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Economic Report
Number 58

This report highlights the outlook for the world economy through 1980. Subsequent issues of the ECONOMIC REPORT will highlight:

Long-Term U.S. Outlook	March, 1980
1981 California Outlook	June, 1980
National Outlook	September, 1980

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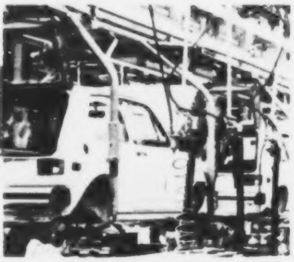

The Outlook for the Industrial Countries

The "oil tax" and tight money to cut growth significantly in 1980. Inflation should be controlled by mid-year, but payments deficits will widen.

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The Outlook for OPEC

After virtually disappearing in 1978 the OPEC current account surplus has again become an important factor in the international economic and financial situation.

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The Outlook for the Developing World

Oil will be the key factor in the greatly disparate economic performances of the non-OPEC developing world in 1980. Trends in the aggregate will be poorest of last five years, but group should recover more quickly.

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Trade Trends and the U.S. Dollar

The U.S. current account deficit in 1979 should decline to $4 billion from $13.9 billion in 1978. In 1980, a modest surplus of $0 to $2 billion is forecast, the first surplus since 1976.

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The Domestic Outlook

Inflation, high interest rates, and slowed growth of the money supply should produce declines in real growth well into 1980. The recession in California should be milder than the U.S. experience.

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Summary

The world was reminded on several occasions in 1979 of the fragile balance of supply and demand on international oil markets. Stoppages, cutbacks, and even the threat or rumor of reduced production in Iran—which at peak production levels in the second half of 1978 accounted for less than ten percent of free world oil production—were sufficient to send buyers scurrying for alternative supplies and spot market crude prices skyrocketing. The decision last spring by other OPEC producers to restrict production and to boost crude prices in real terms for the first time in five years has returned the OPEC surplus to a central position in world economic and financial developments. The oil supply situation has also raised the specters of oil-constrained growth for the world economy and a larger payments imbalance for the non-OPEC developing world. In its July, 1979, *Economic Outlook*, the Organization for Economic Cooperation and Development (OECD) observed:

> For the first time since the days of immediate post-war recovery, there is now a very real risk that the short and medium-term growth of living standards and employment will be constrained by availability of a key industrial input—energy. Supply shortages of industrial raw materials have developed before. But consequent sharp increases in price have typically resulted in a marked increase in availability, and thereafter a fall in price. . . . But the short-run supply response of oil to higher prices is very much lower than for other raw materials, because most suppliers are already producing at or near desired capacity rates, and supply policy in Saudi Arabia seems to have changed. Prospects for OECD growth, therefore, now depends importantly on the likely supply of energy and the efficiency with which it is used.

It cannot, of course, be proven whether the OECD's assessment is either accurate or unduly pessimistic. The proof will depend ultimately on how Saudi Arabia and other OPEC producers view their responsibility for global economic developments, on the political situation in Iran, on the pace of increases in non-OPEC oil production (North Sea, Mexico, etc.), and on the conservation responses of the industrial nations—none of which can be forecast with certainty.

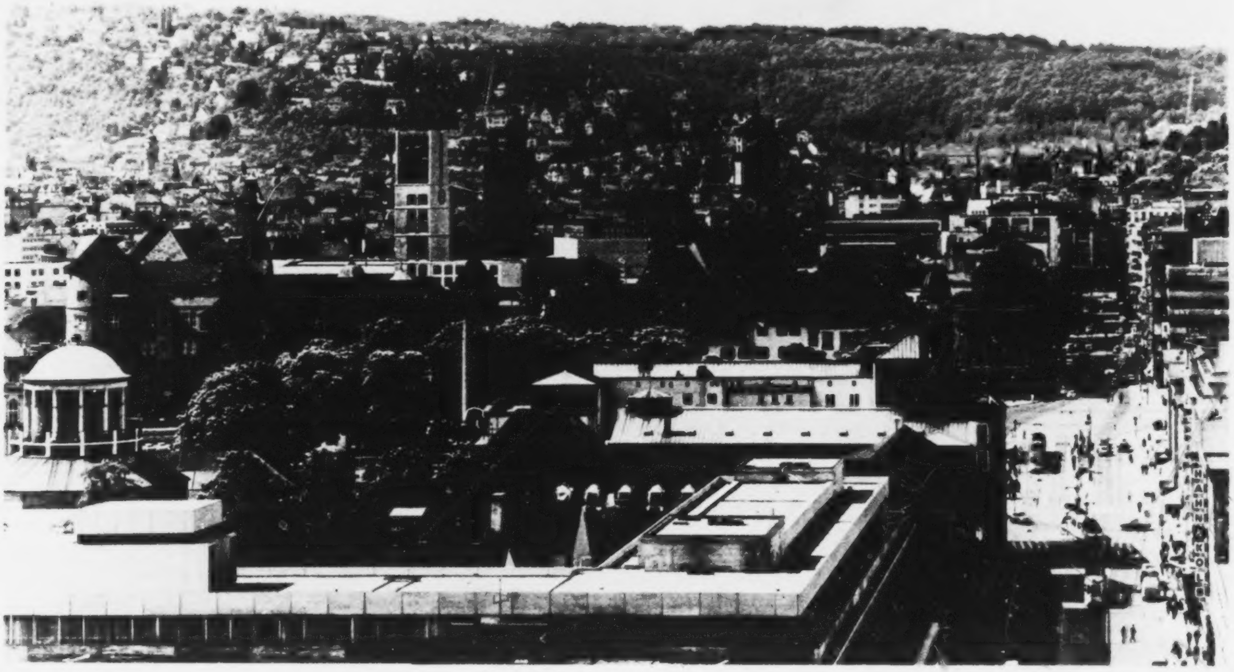
Whatever the true supply-demand picture, however, it is clear that the oil situation and, more specifically, developments in crude oil prices this year have become the dominant concern of economic policymakers and the foreign exchange markets. They have also radically altered earlier expectations of economic developments in the industrial and developing countries in 1979 and 1980.

While last year's economic summit at Bonn worried about how to slow the U.S. economy down and speed up those of Germany and Japan, this year's Tokyo summit focused almost exclusively on oil. The leaders of the seven biggest industrial countries pledged to pay the "oil tax" by allowing a reduction in real incomes to compensate for higher oil prices, and to limit oil imports through 1985 via quotas which will become progressively more binding in the years ahead. On world foreign exchange markets, this year's "oil news" fairly consistently pulled the price of sterling up—despite adverse trends in British inflation and the balance of payments—and aided the recovery of the U.S. and Canadian dollars. The U.K.'s rapidly-approaching self-sufficiency in oil and North America's comparatively low dependence on imported energy were thus judged favorably in the current environment by the markets. Just as consistently, traders sold Japanese yen on "oil news," presumably because of that nation's heavy dependence on imported oil.

The current outlook for the dollar remains relatively positive, based on economic fundamentals, that is, a slowing rate of economic growth in the United States, leading to an improved current account position. Developments in the Middle East, however, will continue to buffet foreign markets. The longer run view, moreover, is consistently for a weaker dollar later in 1980 and in 1981 as U.S. economic growth picks up once again, a trend with less favorable implications for trade and inflation.

For developing countries not belonging to OPEC, the combination of higher oil prices and slowed growth in the industrial world means, generally, slower economic growth, larger current account deficits and a new boost to inflation. There are, nevertheless, several important exceptions to the expected patterns. The group as a whole, moreover, has been making progress toward insulating developing world economies from such disruptions, by, as examples, diversifying trading patterns, amassing large totals of international reserves, and in many cases, by better economic management. Thus, the 1980 economic performances of this large and diverse group of nations promises to be the least favorable of the past several years. Nevertheless, provided that the world recession does not deepen or lengthen more than currently expected, the group should be able to resume such progress relatively more quickly than was the case resulting from the 1974–1975 downturn.

The Outlook for the Industrial Countries



Stuttgart, West Germany

Inflation Speeds Up in 1979

The effects of the boost in crude oil prices on the developed world are most visible in the recent acceleration of wholesale and consumer price increases, and in the dramatic swing in industrial countries' current account balances since last year. Between late 1978 and October of this year, for example, the year-over-year rate of increase in wholesale prices had nearly *doubled* in most of the major industrial countries outside the U.S. (Canada excepted), while many of the smaller industrial countries suffered even more dramatic upsurges in wholesale prices. In the OECD area as a whole, the weighted average rate of increase in consumer prices reached a low point of 7.5% in April, 1978, rose modestly over the balance of last year, and then accelerated sharply over the first seven months of 1979. In October, the OECD estimated that the year-over-year rate had risen to 11% by July, i.e., an increase of almost 47% in the OECD inflation rates since the low point. More recent data from individual OECD member countries suggest a continued rise in the area-wide index through October. For 1979 as a whole, SPNB now estimates the weighted average rate of inflation in the OECD area at 9.7%, versus 7.6% in 1978.

While higher crude oil prices were the most obvious explanation for the acceleration of inflation, they were certainly not the only cause. The strenthening of the U.S. dollar against most major currencies since November, 1978 (discussed in greater detail in a subsequent section of this report) reversed a two-year trend which had effectively held import

KEY INDICATORS FOR SELECTED INDUSTRIAL COUNTRIES

	Real Growth (Percent)			Consumer Prices (Percent Change)			Current Account Balances (Millions of $ U.S.)			Unemployment Rates (Percent)		
	'78	'79E	'80F	'78	'79E	'80F	'78	'79E	'80F	'77	'78	'79
Major Industrial Countries												
United States	4.4	2.0	-2.0	7.7	11.2	12.1	-13,895	-4,000	1,000	7.0	6.0	5.8(Sep.)*
Japan	5.6	5.3	3.8	3.8	4.0	8.0	16,534	-5,000	-3,000	2.0	2.2	2.1(Aug.)*
Germany	3.5	3.8	2.0	2.6	4.3	4.0	8,772	-1,000	-2,500	4.6	4.4	3.8(Sep.)*
France	3.3	3.0	1.7	9.2	10.5	10.5	3,976	1,500	-500	4.9	5.0	5.9 (Aug.)
United Kingdom	3.2	1.0	-1.5	8.3	13.5	16.0	845	-5,500	-1,000	5.8	5.8	5.4(Oct.)*
Canada	3.4	2.5	1.0	9.0	9.2	9.0	-4,619	-6,000	-6,500	8.1	8.4	7.6(Sep.)*
Italy	2.6	4.0	2.4	12.1	15.0	14.0	6,286	4,200	1,500	7.2	7.2	7.4 (Q2)*
Other Industrial Countries												
Australia	2.7	3.8	2.5	7.9	9.2	9.5	-3,818	-3,000	-3,600	5.6	6.3	6.3 (Sep.)
Austria	1.5	3.8	2.5	3.6	3.8	4.0	-1,526	-1,900	-2,000	1.8	2.1	2.4 (Jun.)
Belgium(1)	1.6	2.5	1.9	4.5	4.6	5.5	-567	-1,600	-2,400	6.6	7.0	7.1 (Sep.)
Denmark	1.0	2.3	1.0	10.1	9.5	10.5	-1,476	-2,600	-2,900	7.7	7.4	6.2 (Jun.)*
Finland	2.5	4.2	2.0	7.5	7.5	9.5	578	400	-300	6.1	7.5	6.6 (Jun.)
Ireland	7.0	3.0	2.7	7.6	13.0	13.5	-287	-1,100	-1,400	9.6	8.9	8.1 (Aug.)*
Netherlands	2.5	2.5	2.0	4.1	4.3	6.0	-1,205	-600	-1,200	5.3	5.2	5.2 (Sep.)*
New Zealand	0.5	1.5	1.4	11.9	13.5	14.5	-395	-1,100	-1,400	N.A.	N.A.	N.A.
Norway	3.5	2.0	3.0	8.1	5.1	6.5	-2,144	-1,000	-500	0.9	1.1	1.5 (Aug.)
South Africa	2.3	3.2	3.8	10.2	13.1	14.2	1,623	3,200	600	0.6	0.7	0.6 (Apr.)*
Spain	2.9	2.8	2.0	19.8	16.0	17.0	1,509	1,000	100	5.7	7.5	8.7 (Q2)
Sweden	2.8	4.5	3.0	9.9	7.3	8.5	-981	-3,000	-3,700	1.8	2.2	2.2 (Aug.)
Switzerland	0.9	1.5	1.0	1.1	3.6	4.0	4,430	4,000	3,000	0.4	0.4	0.4 (Sep.)
Total, OECD Countries(2,3)	3.9	2.9	0.5	7.6	9.7	10.7	8,689	-30,900	-33,400			
OECD Excluding United States(2,3)	3.6	3.5	2.0	7.5	8.8	9.8	22,584	-26,900	-34,400			
EEC Countries(2,4)	3.1	3.0	1.4	6.8	9.0	9.3	16,344	-6,700	-10,400			

(1) Current Account Balance includes Luxemburg.

(2) Aggregate figures for country groups are weighted averages (except current account balances, which are sums). Weights for both real growth and consumer prices are 1978 GDP at 1975 prices and exchange rates.

(3) Includes Greece, Iceland, Luxemburg, Portugal, and Turkey in addition to countries shown, but excludes South Africa.

(4) Includes Luxemburg in addition to the eight Eurpoean Community countries shown.

(5) National definitions (except Ireland: EEC definition), not seasonally adjusted except where indicated by asterisk.
1979 figures are averages through month or quarter shown.

E = Estimate F = Forecast

prices down in Japan and most of the European countries. It is estimated that about half of the free world's trade—including crude oil and many important traded commodities—is transacted in dollars. Thus the dollars' recovery aggravated the rise in local currency import prices overseas, particularly for oil. Second, crude oil was not the only important commodity whose price increased in 1979. As of the end of October, *The Economist's* dollar indices of prices of industrial raw materials and food were both over 14% above year-earlier levels, while metals prices were up more than 20%. World food prices were pulled up primarily by the impact of the poor Russian grain harvest, while metals prices were buoyed by several factors: strong industrial demand; official stockpiling of strategic materials; speculative purchases in late summer; and, on the supply side, transportation difficulties. Finally, increases in indirect taxes magnified inflation rates in several European Economic Community (EEC) countries this year. Such increases are reflected in retail sales prices.

As shown in the accompanying table, the acceleration of inflation in the OECD area this year was far from uniform. The sharp increase in the U.S. rate of inflation—from 7.7%

in 1978 to an estimated 11.2% this year—pulled the overall OECD index up by almost one full percentage point, while the larger EEC countries accounted for most of the increase in the inflation rate among the other industries. On a year-over-year basis, inflation accelerated only marginally in Canada and Japan, while rates stabilized or fell in a number of smaller developed nations.

OECD Balance of Payments Hit Hard

The combination of commodity price increases, a pick-up in import demand in most OECD countries, and exchange rate movements in 1978 and 1979 produced dramatic turnaround in the aggregate current account balance of the industrial nations in 1979. By mid-year, five of the seven largest OECD countries—the U.S., Canada, Germany, Japan, and the U.K.—were running current account deficits, versus only two in 1978, while the current account positions of most of the other industrial countries had also begun to deteriorate significantly. While the U.S. still posted a deficit at mid-year, the nation's current account balance had in fact improved markedly from the year-earlier period. Despite a much higher oil bill, a reduction in the U.S. current account deficit of about $10 billion is now expected for the year as a whole.

The amelioration of the U.S. balance of payments position suggests that the rest of the OECD area will have suffered an adverse swing in its aggregate current account position of nearly $50 billion between 1978 and 1979—from a surplus of over $22 billion last year to a deficit of almost $27 billion in 1979. By far the largest individual country share of that shift was Japan's; the nation's 1978 surplus of $16.5 billion had eroded by the first quarter of this year into a deficit which is now expected to mount to $5 billion by year-end. Strong import demand, special programs to reduce the trade surplus earlier in the year (voluntary export restraint and "emergency imports"), a weak yen, and a sharp jump in the bill for imported oil and other raw materials were among the factors responsible for the huge shift in Japan's external position. Also notable were the large swings from surplus into deficit recorded by Germany and the United Kingdom, the latter despite both a strengthening currency and the growing contribution in North Sea oil to the balance of payments.

Real Growth Slows

Real growth prospects for the OECD countries in 1979 have also been adversely affected by developments in oil prices, although here the impact is less direct than on inflation and payments balances. Also, since the bulk of this year's OPEC price increases occurred from mid-year onward, their full impact on growth in the industrial countries is expected to be delayed until 1980. Higher oil prices affect real GNP or GDP growth in oil-importing countries by reducing the flow of spendable income in the domestic economy. Because of the relatively low elasticity of demand for most oil-based products in the short term, proportionally more of a given individual or company income must be spent on oil, and correspondingly, less on other goods and services. This so-called "oil tax" is paid to the oil exporting countries, causing a net reduction in spending and income in the OECD countries until such time as the money flows back in the form of investments and purchases of goods and services by the oil-exporting nations. Further, economic policies designed to counteract the inflationary and balance of payments impact of higher oil prices serve to exacerbate their growth-inhibiting impact, although with a time lag. As discussed more fully below, economic policies in many of the industrial countries have shifted decisively in this direction during 1979.

Last year at this time, real growth among the OECD countries other than the U.S. was widely forecast to accelerate modestly in 1979, paced primarily by the EEC countries. A deceleration for the OECD area as a whole was in the cards, however, due to a considerable slowdown expected in the United States. In the event, the U.S. slowdown did materialize. However, according to SPNB's estimates, 1979 GDP growth in the rest of the OECD area, including the European Community as a whole, also slowed marginally. As a result, the OECD economies grew by only an estimated 2.9% in 1979, one full percentage point less than in 1978.

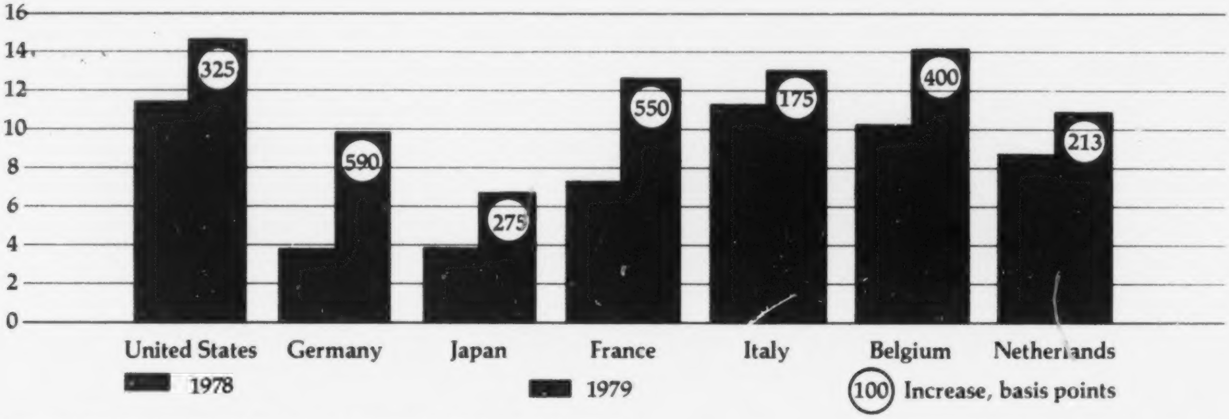
Among the seven largest industrial nations, only Germany and Italy appear to have succeeded in attaining higher growth than in 1978, and the performances of the French, the Canadian, and particularly the British economies fell well below expectations. By contrast, many of the smaller developed nations experienced a substantial pickup in the pace of economic activity in 1979. Noteworthy in this respect was the Scandinavian region (with the exception of Norway, where deflationary measures were imposed in 1978 to cool an overheated economy), where economic growth has been minimal since 1976.

Economic Prospects in 1980

Economic forecasting is always subject to uncertainty, but the year-ahead view from late 1979 seems to have more than its share of significant unknowns. The chain of events put in motion by the take-over of the U.S. Embassy by students in Teheran, which at this writing had resulted in a U.S. boycott of Iranian oil and the freezing of Iranian assets in American banks, could well have important unforeseen consequences for the world economy in 1980. Among the possibilities are: interruptions in oil supplies and stronger-than-expected upward pressure on oil prices; disruption of the normal flow of payments through the international banking system; a speedup in the ongoing process of international reserve asset diversification; and increased volatility on the world's foreign exchange markets.

The magnitude of the global payments imbalance, which

MONEY MARKET INTEREST RATES IN EARLY NOVEMBER*
(Percent)



*3-month, local currency interbank deposit rates at or near end of first week of November.

is expected to increase next year, must also be listed as a source of concern. There is certainly no inherent, systemic reason why the non-OPEC world's current account deficit cannot be financed as it was in 1974-1975, i.e., largely through the intermediation of private banks. Yet the problem is compounded this time by the fact that much of the credit extended by banks to oil-importing countries in 1974 and 1975 is due to be repaid in the near future.‡ Thus refinancing needs will be added to the new borrowing required to meet 1980 current account deficits. In today's global economic environment, the risks inherent in international financial intermediation are clearly increasing. Unless the rewards—in terms primarily of "spreads" on Eurocurrency loans—increase commensurately, we suspect that private banks will be unwilling to shoulder as large a proportion of the petrodollar recycling burden as they did in the 1974-1975 period.

Finallly, it is difficult to predict exactly how consumers and businessmen will behave in an environment characterized by still-accelerating inflation, tightening monetary policy, slowing growth in both real GDP and the volume of world trade, and rising unemployment. SPNB's forecast for the industrial countries, is presented here, as it stands. On balance, never the less, in view of the factors mentioned above, we are obliged to conclude that any errors in our forecast are likely to be on the side of optimism; that is, inflation rates and current account deficits could conceivably turn out higher, and real growth rates lower, than our forecast suggests.

The following sections discuss recent developments in monetary policy and the outlook for the industrial nations as a group in terms of real growth, inflation, and payments balances. Prospects for the six largest industrial countries outside the U.S. are then examined in more detail.

Inflationary Pressure to Ease by Mid-Year

It now appears likely that the industrialized world will have to digest yet another lump of oil price-induced inflation in the first quarter of 1980. There is a danger also that trade unions in a number of countries will attempt to incorporate this year's inflation into excessive wage demands in late 1979 and early 1980. Further, recent sharp increases in wholesale prices have not yet been fully reflected in consumer prices in a number of OECD countries (e.g., Japan, Canada, Belgium, Sweden, and Norway).

Despite these factors, we anticipate that inflation in the OECD area will have reached its peak by mid-1980. The tough stance of monetary policy in many industrial countries should succeed in breaking inflationary expectations, while slowing GDP growth will ease pressure on both domestic prices and prices of internationally-traded commodities. Declining rates of inflation in the second half of 1980 should provide latitude for some easing of fiscal and monetary policies in the OECD countries, raising the likelihood of fairly sharp declines in domestic short-term interest rates by year-end.

The expected peaking in OECD inflation will not occur soon enough, however, to prevent consumer prices in 1980 from showing a bigger year-over-year increase than in 1979. The average rate of inflation in the OECD area, both including and excluding the U.S., is expected to rise by about one percentage point in 1980. Increases in average inflation rates are forecast to occur in most individual OECD countries as well, the exceptions being Germany, Italy, Canada, and France.

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‡Maturities on the $50 billion total of Eurocredits extended in 1974 and 1975 averaged about 7½ and 5½ years, respectively. Although part of this total has subsequently been refinanced by the borrowing countries, it nevertheless appears, that there is a significant bunching of final maturities in the 1980-1982 period.

Payments Deficit Continues to Widen

The aggregate current account deficit of the OECD countries is expected to increase again in 1980, although by only an additional $2½ billion. The overall OECD figure, however, masks major improvements in the current account positions of the U.S., the U.K., and, to a slightly smaller extent, Japan. As discussed in more detail in a later section of this report, the recession in the United States, juxtaposed against continued positive GDP growth among most of its leading trading partners, is primarily responsible for the shift from deficit to small surplus shown in the table. Stronger U.S. growth in the second half of 1980 should benefit Japanese exports, as will the increased competitiveness stemming from depreciation of the yen in 1979. The expected improvement in Britain's current account is a product of North Sea oil (the U.K. will be self-sufficient in oil in 1980) and depressed domestic demand. Norway's current account deficit is also expected to be trimmed by rising oil output.

The further widening of current account deficits (or shrinkage of surpluses) in the rest of the industrial countries in 1980 results basically from two factors. First, because of the timing of OPEC price moves in 1979, the *average* price increase in 1980 is expected to be greater than in 1979. Stated another way, OECD consumers will be paying substantially higher oil prices for a full year in 1980, as opposed to the situation in 1979 when the bulk of the increase occurred in the second half. Higher oil prices not only affect the merchandise trade balance; they also raise the cost of, and tend to discourage demand for, services such as transportation and tourism. The latter are important net foreign exchange earners for many OECD countries, particularly those in the Mediterranean region.

The second factor is the growth slowdown in the OECD area. OECD countries are their own best customers, as illustrated by the fact that over 70% of total OECD exports are shipped to OECD countries. Thus slackening domestic (and hence import) demand in the area creates a sort of "inward multiplier effect," shrinking the volume growth of trade and making it difficult for individual OECD countries to improve their trade balances.

The further expansion of current account deficits in most OECD countries has an important positive aspect in the global context. In effect, it means that the OECD countries in 1980 will continue to shoulder a major share of the burden of the OPEC surplus, giving less developed countries more time to adapt to higher oil prices. That is, if the industrial countries were to significantly reduce their current account deficits in 1980, they would do so presumably by cutting import growth sharply, making it extremely difficult for developing countries to earn the foreign exchange needed for oil and other essential imports.

CENTRAL BANK DISCOUNT RATE IN MID-NOVEMBER

(Percent)

	1978	1979	Increase (basis points)
United States	9.5	12.0	250
Japan	3.5	6.25	275
Germany	3.0	6.0	300
France	9.5	9.5	0
United Kingdom	12.5	17.0	450
Canada	10.75	13.0	225
Italy	10.5	12.0	150
Belgium	6.0	10.0	400
Netherlands	6.5	8.5	200
Switzerland	1.0	2.0	100

Monetary Brakes Slammed On

The response of economic policymakers in the industrial countries to the balance of payments and inflationary developments of 1979 has been a distinct shift toward more restrictive economic policies. Although the OECD noted in its mid-year *Economic Outlook* that for a number of reasons fiscal policies in the major OECD countries in 1979 were also proving less stimulative then expected, the cutting edge of the policy shift for most industrial countries has been monetary policy; in particular, increases in interest rates designed to slow the growth of money and credit and arrest inflation.

While the OECD countries were busy "leapfrogging" oil prices in 1979, a similar process appeared to be taking place with central bank discount rates. As the table on this page shows, official interest rates in a number of important industrial countries have been hiked sharply over the past twelve months—in the cases of the U.S., Canada, and the U.K. to record levels. Moreover, the majority of the increases were posted between March and November of this year, a period which was understandably characterized by some observers as an "interest rate war."

The reaction in domestic money markets to higher central bank rates and tighter money was an even sharper jump in short-term interest rates, as shown in the table. Increases in money market rates were especially pronounced in Germany and in France, the latter reflecting tight credit market conditions even in the absence of a hike in official rates. The shift to a more restrictive monetary posture was aided in the major industrial countries outside the U.S. by the recovery of the dollar since the end of October, 1978. The necessity for central banks in Japan, Switzerland and Germany to intervene periodically—and at times quite heavily—in the foreign exchange market to support their own currencies against the dollar served to effectively soak up domestic liquidity. Likewise, German intervention and increases in the Bundesbank's discount and lombard rates forced many of the other members of the European Monetary System (EMS) to raise official rates and to intervene to keep their currencies at par with the deutschemark.

The sharp upward movement of short-term interest rates during 1979 was a signal to the markets that central banks do not intend to print the money to pay for increased oil prices. We feel it is unlikely that interest rates overseas will come down significantly until central banks have become convinced that inflation has stopped accelerating. Depending on the evolution of oil prices, this situation might not occur until well into the first half of 1980.

Growth to Slow Further

Developments in 1979 and prospects for 1980 regarding inflation and balances of payments among the OECD countries are likely to prompt many governments to tighten fiscal policies in line with monetary policy. A number of industrial country governments have already announced reductions in the growth of public spending and/or lower planned deficit/GDP ratios for 1980 (Germany, France, Belgium, U.K., Japan, Denmark), and more countries are certain to follow. Even in cases where spending growth is not curbed in nominal terms, inflation is likely to reduce the growth of government purchases in real terms, while at the same time increasing the tax bite through so-called "fiscal drag."

Higher oil prices, the reduced availability and higher cost of credit, and the likely area-wide diminution in fiscal stimulus will all act to curb the growth of real incomes and domestic demand in the OECD area in 1980, reducing export expansion possibilities within the area as well. The burden on consumers may be eased to some extent by faster growth of earnings than in 1979 (see next section). But the latter will have to be carved out of company profits, as it will be difficult for businesses to pass on higher costs to the consumer in an environment of slackening demand. Fixed investment in residential and industrial construction appears likely to be especially hard-hit by interest rate developments. Machinery and equipment spending, which has been surprisingly buoyant over the past 12–18 months in the major industrial countries, is also likely to slow as capacity utilization rates begin to recede and profit expectations are trimmed.

SPNB's forecast is that real GNP/GDP growth in the OECD area as a whole in 1980 will amount to only about ½ of one %, down from almost three percent in 1979. The aggregate OECD growth figure is, of course, heavily influenced by the forecast recession in the U.S., which accounts for about 38 percent of OECD real GDP. Even excluding the U.S., however, real growth in the remaining OECD countries may only be about 2% next year. Japan and Canada are the two countries most directly affected (via exports) by the U.S. recession, although a U.S. downturn normally brings in its wake a diminution in consumer and business confidence in the other OECD countries that leads indirectly to greater caution in spending area-wide.

The EEC countries together in 1980 are expected to grow at only about half the pace of the preceding two years, a development which is largely explained by the forecast recession in the U.K. and the near-halving of French and German growth rates. The slowdown should help to stem inflationary pressure, leading possibly to some relaxation of economic policy by mid-year, but EEC unemployment rates are likely to rise again in 1980 after stabilizing or declining in most countries in 1979.

Canada

The most significant development affecting expectations for Canada's economy in the near term is the forecast recession in the United States—to which Canada is very closely linked through trade and financial ties. The U.S. is the market for more than two-thirds of Canada's exports, on which, moreover, the nation depends for around a quarter of GNP. Stability in Canada's balance of payments and her currency also depends on capital inflows from the U.S., meaning, in effect, that Canadian monetary policy must follow U.S. initiatives.

Canada's economic outlook, therefore, is considerably less optimistic than it was at the beginning of the year, when stronger growth, lower inflation, and a larger trade surplus were being forecast. Exports to the U.S. will stay weak through most of 1980, while the recovery of business investment in Canada—which was expected to be the mainstay of the domestic economy—will be adversely affected by stagnant consumer and external demand, and by high interest rates. Inflation, a bright spot in early expectations due to the successful pursuit of a policy of monetary restraint and a moderation in wage growth over the last few years, has also worsened once again due to energy and food costs. After a 3.4% real economic growth rate for 1978, therefore, Canada's GNP is expected to expand by only 2.5% during 1979 and 1% in 1980; by the end of 1980, however, a recovery should be well underway. Consumer price inflation seems likely to remain at around, or perhaps slightly below, 1979's 9.2% pace. Finally, further deterioration is expected in Canada's current account balance, on the basis of a declining trade surplus during both 1979 and 1980 and high interest payments on the nation's external debt.

Canada's economic trends will thus follow fairly closely those of the U.S. economy in most respects, with the important exception of trade and current account developments. This pattern will contrast somewhat with the situation in 1974-75, when the Canadian economy enjoyed a substantially better performance than the U.S. economy, due to the optimism generated by Canada's more favorable oil position and an easier policy environment in Canada. The course Canada is expected to follow thorough 1980, however, should leave the nation in a better position for stronger, more stable growth than in the years following the last recession, which were marked by inflation, persistent current account deficits, and steep declines in the value of the Canadian dollar.

France

After three years of the Barre Plan, the French economy has made relatively good progress in achieving some of the goals set out by the plan. In particular, the balance of payments has improved significantly, and the growth of real wages has been satisfactory. The targets of the plan with regard to inflation and unemployment, however, have not been met, and these issues currently dominate French policymaking. Debate in France thus revolves around the classic question of how much stimulus the government should give the economy to help the employment situation without causing too high a rate of inflation.

At present, continued restraint by the govenrment appears likely to prevail, particularly in view of the expected worldwide slowdown. The 1980 budget calls for a significant decline in the budget deficit, and monetary policy, following the general pattern in the industrial countries, appears likely to remain tight. The 1980 outlook could be affected, however, by the approaching of presidential elections in 1981, leading the government to retreat somewhat from its conservative fiscal and monetary policy orientation.

Real GDP is estimated to have slowed somewhat in 1979 to 3.0% from 3.3% in 1978. Continued growth in consumer spending and export demand kept the growth rate relatively strong. At the same time, oil price increases and increased wage rates contibuted to an acceleration in the rate of inflation, with consumer prices rising an estimated 10.5%. Despite the relatively good growth performance the unemployment rate increased from 5. 0% in 1978 to 5. 9% by September, 1979. Oil prices, in addition to putting upward pressure on inflation, were a principal reason for a decline in the current account surplus to an estimated $1.5 billion in 1979 from $4.0 billion the previous year.

The above policy considerations, higher petroleum prices, and slowing export demand are forecast to bring about a significant slowing in the growth rate in 1980, no improvement in the inflationary situation before the end of the year, and a return of the current account to deficit. Real growth is forecast to slow to 1.7%, while consumer prices should rise at the same rate as during 1979, 10.5%. The current account balance will deteriorate $2.0 billion, moving to a deficit of $500 million.

VW Rabbits on assembly line in Wolfsburg plant.

The outlook for unemployment in these circumstances is not favorable, and government policy debate is likely to continue to center on this issue. By the beginning of 1981, it is reasonable to expect a return to stimulatory policies, but by this time inflationary pressure may be less and export demand should be increasing. The economic progress made by the French economy thus has put the country in a relatively good position to weather the economic buffetings of 1980.

Germany

The German economy, responding to fiscal stimulus and strong export demand, grew in real terms at a rapid 4.3% clip in the first half of 1979. Fixed investment boomed, as expenditures on both residential construction and machinery and equipment rose sharply; the unemployment rate dropped below 4% for the first time in four years; and capacity utilization rates in industry rose to levels not seen since the 1973 boom.

At the same time, however, rising oil prices, the firming of the dollar against the DM, and the reversal of a two-year downtrend in domestic agricultural prices pushed consumer prices steadily upward—to over 5% above year-earlier levels by September. An increase in the value-added tax on July 1 also added to retail price inflation in the second half of the year. The terms of trade setback, coupled with buoyant import demand, shifted Germany's current account position from a surplus in the first quarter of 1979 to a deficit totaling $3.7 billion by the end of the third quarter.

The Bundesbank, responding to the inflationary threat, began tightening the monetary screws in early spring, and by late fall short-term interest rates had risen in Germany by several hundred basis points. Bundesbank officials also persuaded the Federal Government to cut the growth of public spending and prune the public sector budget deficit in 1980.

In recent months consumer confidence has begun to wane and the highly respected Ifo-Institut business climate indicator has ceased rising. The pace of economic activity appears likely to slow in the closing months of 1979 and through most of 1980, reducing real GNP growth next year to 2%

from 3.8% in 1979. Germany's current account should post a surplus in the fourth quarter of 1979, benefitting from the usual seasonal pickup in exports and slackening import demand. Nevertheless, we forecast a deficit of $1 billion for the year as a whole, widening to $2.5 billion in 1980. German exporters should be able to step up sales to OPEC and the Eastern European countries, as they did in 1974-75, but this will not be sufficient to repair the damages done to the trade balance by higher oil prices and slackening demand for German exports in the U.S. and among Germany's major European trading partners. If our forecast proves correct, this would be the first time in more than two decades that Germany has run back-to back current account deficits.

The Bundesbank's monetary restraint program, together with a probable strengthening of the DM in the months ahead, should succeed in arresting the inflationary spiral by early spring, possibly in time to head off a significant escalation of trade union wage demands, and certainly in time to improve the chances for re-election of Chancellor Schmidt's coalition government in October. On a year-over-year basis, we expect Germany's inflation rate to decline slighty to 4% in 1980.

Italy

Among the major industrial countries, Italy is the second most dependent (after Japan) on imported oil. Nearly 90% of the oil consumed in Italy is imported, and imported oil accounts for almost 60% of total energy needs. In view of this dependence and the fact that Italian economic growth accelerated in the first half of 1979 (causing a pickup in the rate of imports), it comes as no surprise that the nation's trade position deteriorated sharply in 1979. Over the first nine months, Italy's trade deficit totaled Lit 1,571 billion ($1.9 billion) according to recent official figures, almost six times the comparable figure for last year. What *is* perhaps surprising, and testimony to the strength of Italy's "invisible" earnings (services and transfer payments), is that the nation's current account is nevertheless expected to remain in surplus this year by $4.2 billion.

Italy's inflation rate, already the highest among the major OECD countries, was given a sharp upward thrust by this year's oil price increases, which were passed on almost immediately to Italian consumers. By October, the year-over-year figure had exceeded 18%, and an average for the year of at least 15% seemed likely. Interest rates, which had remained unchanged (albeit at comparatively high levels) for over a year, were finally hiked in October; the Bank of Italy's discount rate and commercial banks' prime rate both went up by 150 basis points, the former to 12% and the latter to 16½%. The need to curb inflation in Italy is paramount, because the sliding scale wage adjustment mechanism allows inflation to feed upon itself. The new government, like many before it, has proposed revisions in the sliding-scale system, but there appears to be no particular reason to expect these initiatives to be successful.

Tokyo—Nikon cameras being inspected on production line.

The underpinnings of the acceleration in Italy's real growth rate to 4% in 1979 are expected to give way in 1980. Inflation and increased expenditure on imported oil products will eat into domestically-disposable income and slow the growth of consumer spending; fixed and inventory investment will be hampered by rising interest rates and more pessimistic prospects for sales; and export demand will slacken due to slowing GDP growth in the OECD area. All factors considered, we forecast a return in 1980 to roughly the same rate of growth experiencedby Italy in 1978.

Many of these same trends will operate to whittle Italy's current surplus to $1.5 billion in 1980. Even at that, however, Italy is one of the few industrial countries expected to show a surplus at all next year, and the payoff from slower growth could include a slight reduction in the nation's average inflation rate.

Japan

Economic growth for Japan will be slower in both 1979 and 1980. After expanding 5.6% in real terms in 1978, the Japanese economy is forecast to expand at a lower 5.3% in 1979 and only 3.8% in much of 1980. The economy has been growing in 1979 primarily because of strong consumer demand and increased investment levels. A pronounced decline in economic growth during 1979 and 1980 will be the result of reduced growth in consumer spending and lower growth rates for Japanese exports. The growth in consumer spending will be reduced as prices begin to rise and real wages fall, in addition to the appearance of a more cautious attitude on the part of consumers. Furthermore, changes in both fiscal and monetary policy will restrict growth. Japanese fiscal policy, which has been relatively expansionary to date, will have to be restrained during 1980 to fight inflationary pressures and to retard the intolerably high rates of growth of public-sector debt. Likewise, monetary policy will become tighter to combat inflation.

In 1979 consumer price rises have been relatively small. The consumer price index will have risen only about 4.0% in 1979, up marginally from the 3.8% rise in 1978. We feel, however, that it will rise approximately 8.0% in 1980 as rises in wholesale prices, which have been rising about 12.6% in 1979, are finally passed along to the consumer. Moreover, increasing import prices, including rapidly rising oil prices, will contribute additional inflationary pressures which will affect consumer prices. During 1979, the declining value of the yen has magnified the rise in these prices in contrast to 1978 when the increasing value of the yen reduced effective import price increases.

In 1978, one of the major strengths of the Japanese economy was the international sector. However, after registering a mammoth current account surplus of $16.5 billion in 1978, Japan is incurring a deficit of approximately $5.0 billion in 1979. This dramatic change appears to bear out the Japanese contention that the 1978 results were a short-run fluke and that their economy, on the international level, is exceedingly exposed. The current account during 1980 is forecast to post another deficit although smaller, of $3.0 billion. The major factors in explaining the 1980 current account deficit will be the large hikes in oil prices and the rise in the prices of other Japanese imports. In addition, the substantially reduced rates of economic growth for the other industrialized nations will mean a weakened export market for Japan.

By the end of 1980, the economy should begin to expand at higher rates, and the yen should have regained some of the value lost during 1979 and the first part of 1980.

United Kingdom

In general elections held in May, 1979, the Conservative Party won a 43-seat majority in the House of Commons, the U.K.'s first clear-cut parliamentary majority since June, 1970. The chief priorities of the new government are: first, to reduce the share of the public sector in economic activity, through cuts in both taxes and public spending; second, to curb the power of trade unions in Britain.

The first priority was attacked in Chancellor Howe's initial budget on June 12, which completely altered the outlook for the U.K. economy in 1979–80. The key measures—cuts in income taxes offset almost exactly by a sharp increase in indirect taxes—alone will produce a recessionary impact on the economy in the short run, by shifting the burden of overall taxation from the higher-paid (who have a higher propensity to save) to the lower-paid (who have a higher propensity to consume). Adding to this the relative deflationary impact of a reduced public sector borrowing requirement in 1979–80, especially in real terms, and tighter monetary policy, the outlook for real GDP growth in 1979 and 1980 is dim.

Real GDP declined slightly in the first quarter of 1979 (compared to the preceding quarter) and then rebounded sharply in the second. Special factors were at work in both quarters: strikes and severe winter weather in the first; and in the second, a sharp rise in North Sea oil production and a consumer buying binge to beat the anticipated VAT hike. In the second half of 1979, we expect real GDP on balance to show a slight decline, bringing real growth for the year as a whole to about 1%.

The budget's boost in VAT added a further upward push to an inflation rate that was already accelerating under the impetus of faster earnings growth. From its low point of 7.4% in June, 1978, the year-over-year rate of increase in consumer prices escalated to 16.5% in September and was expected to increase further in the fourth quarter. (It is estimated that the rate woule be 3½–4 percentage points lower if VAT had not been increased.) On average, we expect consumer prices to climb by 13½% in 1979, followed by about 16% in 1980. Despite the higher average, Britain's inflation rate will probably decline fairly substantially in the second half of next year, when the distortion caused by this year's VAT increase will disappear.

The Bank of England's response to inflationary pressure has been a steady tightening of monetary policy. Following the abolition of exchange controls in late October and the publication of disappointing money supply figures in November, the Bank raised MLR by an unprecedented 300 basis points, to a record 17%. The monetary authorities also extended the "corset" on growth of bank liabilities until June, and announced their intention to contain growth in sterling M3 to a 7–11% range until October. In view of the prospective rate of inflation, even if the Bank overshoots its monetary growth target somewhat current monetary policy must be viewed as quite restrictive.

With little, if any, growth in real public sector spending likely in fiscal 1980–81, tight money, high inflation, and sluggish export markets, real GDP is expected to decline next year by 1½%. The volume of consumer spending is likely to drop, as consumers are squeezed by high interest rates, reduced availability of credit, and a probable decline in real disposable income. Fixed investment is also expected to decline in real terms, as profit growth slows under the impact of rising unit costs and declining demand.

The principal bright spot in the outlook is that falling GDP will sharply curtail the real growth of imports in 1980. As a major importer of food and industrial raw materials, Britain should also benefit (relative to 1979) from more moderate increases in commodity prices next year. Together with the shift to a net oil exporter position, these developments should shrink the U.K.'s current account deficit by $4–5 billion next year. The prospective balance of payments improvement, high interest rates, and the likelihood of a substantial drop in the inflation rate after mid-year should aid sterling's performance on the foreign exchange markets in 1980.

Jakarta, Indonesia

The Outlook for OPEC

After virtually disappearing by 1978, the aggregate surplus on current account of the member countries of the Organization of Petroleum Exporting Countries (OPEC) in 1979 is estimated to have risen to its highest level since 1974. A further, more moderate increase is forecast for 1980, although the surplus is expected to remain somewhat smaller than the record level of 1974. Nevertheless, it could be noted that the combined OPEC surplus for the two years, 1979 and 1980, is expected to be greater than for any previous two-year period. The important implications of this tremendous surplus for the economies of the industrial and developing countries are discussed elsewhere. For the countries of OPEC, the return to substantial surplus has brightened the prospects of several of them of achieving their developmental goals. Indeed, some OPEC members had run into balance of payments difficulties by 1978 that threatened their long-run financial stability. For the surplus countries of the Arabian Gulf, on the other hand, the larger surpluses intensify the problem of protecting the real value of their holdings at a time of high inflation worldwide. Their strategy for doing so could have important effects on international financial markets and exchange rates.

Oil Prices

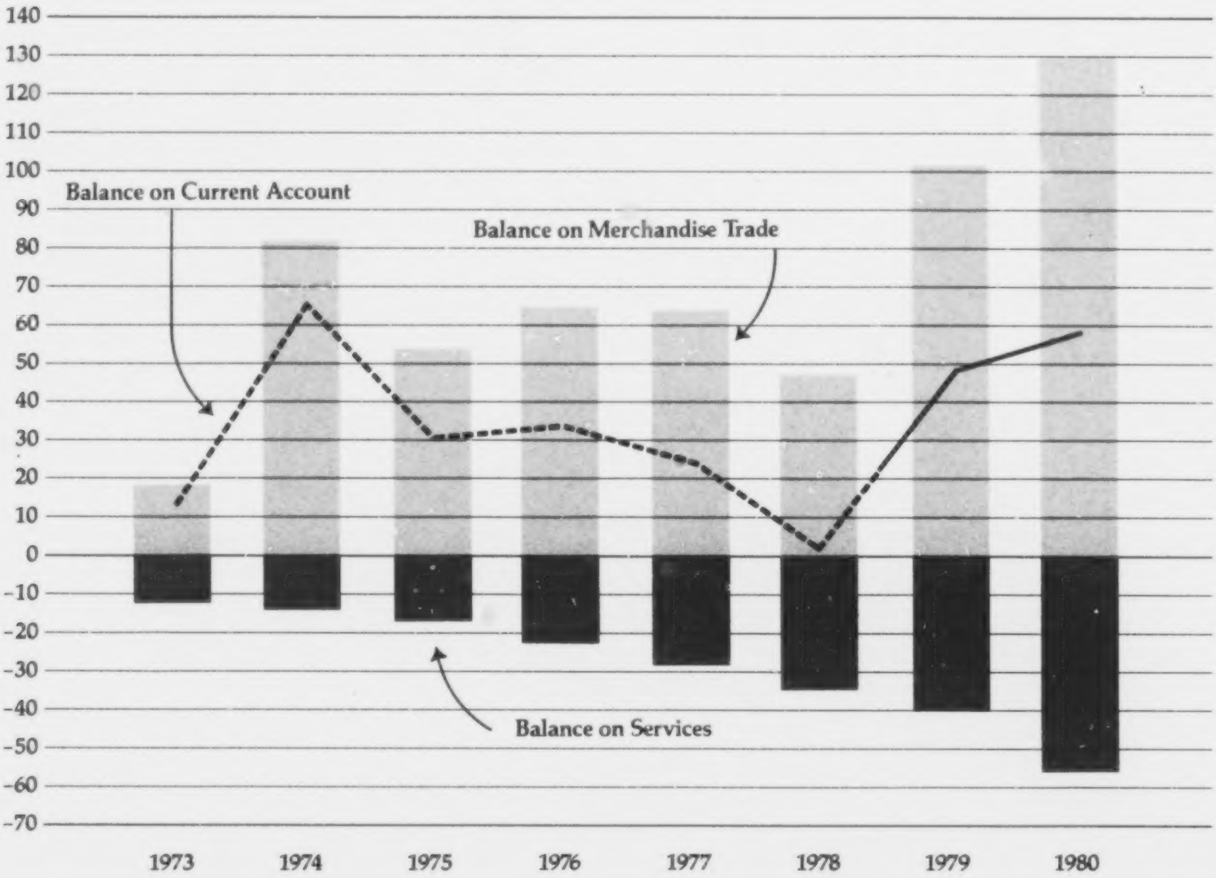
The most important factor in bringing about this dramatic reversal of the OPEC current account position has been, of course, the very substantial rise in petroleum prices during 1979. It is now estimated that, as a result of the price spiral touched off initially by the Iranian revolution, the average price for oil exported by OPEC members will have been 37% higher in 1979 than in 1978. The increase from the end of 1978 to the end of 1979 is estimated at 68%. The occurrence of this rapid rise prior to a formal OPEC decision to raise prices is an indication that, in contrast to the situation of the past few years, constrained petroleum supply is becoming a deterrent to economic expansion, particularly in the industrial world. Also implied by the pattern of the price increases is that the so-called "price moderates" of OPEC—now primarily Saudi Arabia—are ineffective in setting the price during a period of tight supply.

When oil supplies are plentiful, the surplus capacity within OPEC allows Saudi Arabia significantly to affect price through production decisions. When supplies are tight, however, even though Saudi Arabia raises production to a high level, as during most of 1979, the "price hawks" can be effective in raising prices, despite the apparent displeasure of Saudi Arabia. Indeed, it could even be argued that, in such a situation, the existence of OPEC has a dampening effect on price increases, since Saudi Arabia, with nearly one third of OPEC production, has adhered to the OPEC price for its oil, rather than joining in the price spiral. The average price for OPEC oil is, therefore, lower than it presumably would have been had there been no official price. Of course, it should be emphasized that this is not the case at other times, when OPEC has clearly been a force for higher prices.

Although the pressure on oil supplies should be relieved in 1980 as a result of slower world economic growth, the constraints on supply give every indication of being intensified in the next few years. These constraints are of several varieties. First, the shutting down of Iranian exports early in 1979 resulted from a revolution. Furthermore, the Iranian revolution appears to have brought about the loss of perhaps 3 million barrels a day (b/d) of production capacity for the foreseeable future. While similar revolutions appear unlikely in other OPEC members, political instability as a source of supply constraint cannot be discounted in several areas. Most such disruptions are likely to be on a small scale and not as permanent as the radical transformation that has taken place in Iran, but even temporary interruptions of supply have the potential of bringing about further price increases in periods of rising demand.

A second, and more far-reaching, source of supply constraint among OPEC members is rising domestic demand. It has been estimated that, during the past decade, consumption of energy within OPEC grew at an annual rate of approximately 15%. Rising standards of living and the establishment of energy-intensive industries within OPEC countries can be expected to continue this trend. While domestic demand has not yet become an important constraint on total OPEC supply, it has limited export growth in certain countries, including Algeria, Ecuador, Indonesia, and Venezuela. Even among some of the large surplus countries, plans for energy-intensive industries indicate

OPEC BALANCES ON MERCHANDISE TRADE, SERVICES, & CURRENT ACCOUNT 1973-1980
($ U.S. Billions)



that, at some point, supply could be constrained as a result of domestic usage.

A third factor that appears to be increasingly affecting OPEC oil supplies in the current economic environment is the forecast rate of return on oil held in the ground relative to the rates of return on the financial assets held by OPEC governments. In the present inflationary environment, certain OPEC governments without a need for immediate income question the wisdom of producing oil at high rates when the real return on their surplus funds is small or even negative. Some cutbacks in production in 1980 may occur as a result of the desire by the countries concerned to protect the value of their total portfolio, including oil. Of course, there is a point where such cutbacks become counter-productive, as the value of other assets held by the same countries is certainly affected by petroleum-induced inflation.

The above considerations indicate that, at least for most of the 1980's, either the oil consuming countries will have to keep growth in petroleum consumption at a low level through conservation or petroleum prices will continue to rise substantially. In 1980, however, demand for OPEC oil is forecast to decline due to the recession in the United States, slow growth in the other industrial countries, and increased oil producton in other parts of the world. Despite this decline in demand, prices in 1980 will average significantly higher as a result of several factors. First, even if there were no change in price after the end of 1979, it is now estimated that the average price in 1980 would be 23% higher than in 1979, since important price hikes occurred during the second half of 1979 and the year-end price is forecast to be 23% higher than the average for the year. Second, Saudi Arabia is expected to raise its price substantially to come up to somewhere near the levels of the other members of OPEC. There appears to be little incentive for OPEC's largest producer to keep its price at a level so far below the market at a cost to itself of up to $10 billion annually. While it would be difficult to make a case that Saudi Arabia is in great need of additional revenues, it is perhaps not insignificant that the country recorded a deficit on current account in 1978. Furthermore, the Saudis are believed to feel that their rejoining a more unified OPEC pricing structure could bring more stability to the market.

A final reason for forecasting higher OPEC prices in 1980 is that there will most likely be a formal price increase at the December, 1979, meeting. At present, although no one can really forecast the organization's actions, there appears to be a growing consensus among OPEC members that a regular pattern of quarterly or half-yearly price increases is called for in order to avoid price spirals like the one of 1979 and to offset the effects of inflation on OPEC's real earnings. Such a pricing pattern appears likely to emerge in the near future, although, as in 1979, there is no guarantee that this pattern will indeed prevent unplanned increases. As already mentioned, however, slackening demand in 1980 makes this type of pricing pattern more likely to succeed than in 1979.

The price of OPEC oil in 1980 is forecast to average 45% higher than in 1979 as a result of the above considerations. This increase will be higher than the 37% increase estimated for 1979. As discussed above, however, more than half of the rise in the 1980 average has already taken place. The change between year-end 1979 and year-end 1980 is forecast at 23%, a substantial decline from the comparable 68% rise in 1979. Thus, while the effects on the balance of payments of both oil-importing and oil-exporting countries will be the most pronounced in 1980, the inflationary effects of oil prices should be declining by the end of 1980.

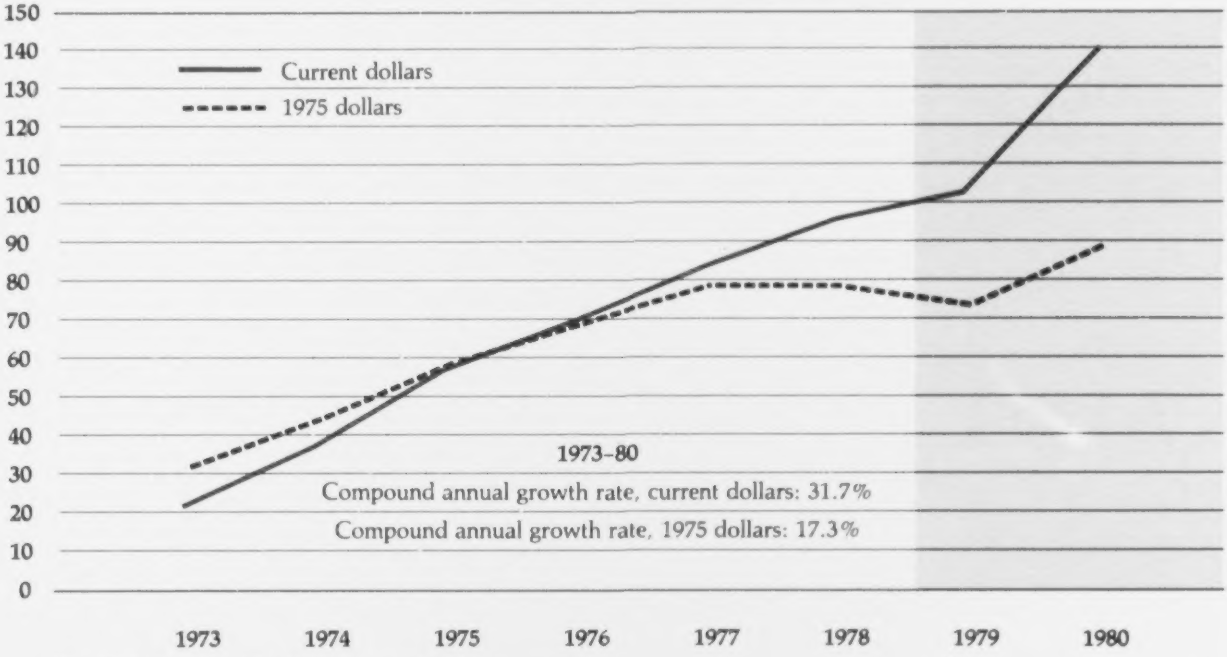
The OPEC Balance on Current Account

By 1978, the aggregate current account surplus of OPEC member countries had fallen to less than $1 billion from its 1974 peak of $63.4 billion. The accompanying table shows that six of the thirteen member countries recorded current account deficits in 1978, including not only some very large deficits in Algeria, Nigeria, and Venezuela, but also a small deficit in Saudi Arabia. A deterioration in the merchandise trade account was the principal cause of the drastic drop in the current account surplus in 1978, although an increase in the deficit on services also contributed to the fall. While the balance on services is estimated to have deteriorated further in 1979 and is forecast to continue this trend in 1980, a more-than-doubling of the merchandise trade surplus in 1979 and a further increase in 1980 will bring about higher current account surpluses than in any year except 1974.

Although oil production has experienced some significant variations—notably an 11% drop in 1975 followed by a 13% increase the following year—the most important determinants of the OPEC merchandise trade balance have been the volume of imports and the terms of trade. After the initial, large oil price increases of 1973–1974, the nominal value of imports by OPEC countries rose much more rapidly than the nominal value of exports through 1978. The compound annual growth rate of imports was 27%, while exports grew only 5% annually. Unfortunately, there is a lack of data to evaluate accurately the volume of OPEC imports. The accompanying chart uses a price index for industrial country exports to estimate the real growth in imports. This export price index rose at an annual rate of 9%, indicating that "real" OPEC imports increased approximately 17% annually from 1974 to 1978. During 1978 alone, there was virtually no real increase in OPEC imports, despite a 14% rise in their nominal value.

OPEC itself would dispute the above methodology of estimating the real increase in its imports. Indices of industrial country exports are heavily weighted by goods sold to other industrial countries and, thus, may not reflect trends in goods sold to OPEC. The OPEC Department of Eco-

OPEC MERCHANDISE IMPORTS IN CURRENT AND 1975 DOLLARS
($ U.S. Billions)



Note: OPEC imports were deflated by an index of industrial country exports.

nomics and Finance attempted to construct an index of import prices and estimated a much higher rate of increase. This would indicate an even lower "real" rate of increase in OPEC imports. While the evidence is not conclusive either way, it would seem highly probable that the terms of trade did indeed move against OPEC during the 1974–1978 period, as the price of petroleum rose at an annual rate of only 6%.

High rates of increase in the volume and price of OPEC imports, therefore, combined with the low rate of export growth to cause a generally declining merchandise trade balance after 1974. The trade surplus reached a low of $47.1 billion in 1978, despite the earlier-mentioned lack of growth in the volume of imports during that year. Most of the drop in the merchandise trade surplus in 1978 from $62.8 billion the previous year was apparently due to increased import prices, as exports fell by $3.9 billion, or less than 3%.

In 1979, the price rises for petroleum discussed above, a modest increase in the volume of exports, and an actual decline in the volume of imports are estimated to have caused the merchandise trade surplus to skyrocket to a record level of $101.4 billion. Estimated export revenues rose 43% to $205.0 billion, while the nominal value of imports increased only 8% to $103.6 billion. At the same time, import prices rose by approximately 14%. While the lack of growth in import volume in 1978 was due principally to slow or negative economic growth in a number of countries, including Ecuador, Gabon, Iran, Kuwait, Qatar, and the UAE, the decline in volume in 1979 resulted primarily from the Iranian revolution, which cut imports drastically in what was until 1978 OPEC's largest importer. Import and budgetary restrictions also contributed to a significant decline in Nigerian imports in 1979, and Indonesian imports slowed as a result of the depreciation of the rupiah.

The $54.3 billion improvement in 1979 in the merchandise trade account was offset to a slight extent by an estimated $6.6 billion deterioration in the deficit on services. This increased deficit was brought about by high levels of construction activity in some countries (notably Saudi Arabia), increases in freight and insurance charges as a result of the nominal rise in the value of imports, and certain transactions in the petroleum sectors of various countries. The deficit on transfer payments, public and private, is estimated to have risen only slightly during 1979, as official transfers probably did not rise and the rate of increase of private transfers appears to have slowed. The lack of

CURRENT ACCOUNT BALANCES OF OPEC MEMBER COUNTRIES, 1973–1980
(Including Official Transfers; Millions $ U.S.)

	1973	1974	1975	1976	1977	1978	1979^E	1980^F
Algeria	-445	158	-1,662	-885	-2,325	-3,539	*-2,740*	*-2,720*
Ecuador	6	37	-219	-6	-341	-150	*-50*	*-20*
Gabon	-36	209	58	27	42	*200*	*620*	*720*
Indonesia	-475	597	-1,109	-908	-50	1,249	*1,025*	*1,300*
Iran	155	12,267	4,708	4,713	5,082	*1,900*	*4,500*	*3,400*
Iraq	800	2,618	2,705	*3,500*	*3,000*	*3,200*	*10,900*	*14,660*
Kuwait	1,540	7,360	5,891	6,949	4,766	6,167	*11,850*	*12,680*
Libya	67	1,831	-68	2,437	2,906	1,025	*3,980*	*5,510*
Nigeria	26	4,945	63	-299	-1,357	-3,782	*4,440*	*4,690*
Qatar	*250*	*1,400*	*860*	*870*	*490*	*840*	*1,700*	*2,300*
Saudi Arabia	2,204	23,007	13,931	13,791	12,791	*-58*	*10,400*	*13,300*
United Arab Emirates	*300*	*3,140*	*2,270*	*2,670*	*990*	*925*	*2,550*	*4,540*
Venezuela	861	5,810	2,306	967	-2,050	-4,484	*-1,610*	*-1,380*
Total	5,253	63,379	29,734	33,834	23,944	995	*48,135*	*58,980*

Note: Figures in italics represent SPNB estimates and, for 1980, forecasts   E = Estimate   F = Forecast

growth in official transfers occurred as a result of a general trend toward loans (as opposed to grants) in the foreign aid programs of the large surplus countries and of the reduction in aid payments to Egypt, until recently the largest recipient of OPEC aid.

The overall OPEC current account surplus (the sum of the trade, service, and transfer accounts) in 1979 rose to an estimated $48.1 billion as a result of the combination of the large rise in the merchandise trade surplus, the moderate increase in the deficit on services, and little change in the transfer account. While this surplus figure represents a $47.1 billion increase from the previous year, it is still smaller than the 1974 surplus in nominal terms and, in view of international inflation rates in the intervening years, it must be viewed as significantly smaller in real terms.

The price forecast developed in the previous section implies that, with some reduction in the volume of OPEC oil exports, total export revenues will rise about one third in 1980 to $271 billion. Imports by OPEC countries are forecast to rise somewhat more rapidly, reaching a total of $142 billion. The significant rise in the rate of import growth after two years of fairly slow growth is expected to occur as a result of two factors. First, several countries that were experiencing financial constraints will be able to pursue economic growth objectives more vigorously as a result of increased oil revenues. Second, the success of anti-inflationary policies in a number of OPEC member countries, particularly in the Arabian Gulf area, should allow these countries once again to increase investment in major public sector projects, which had been slowed to combat inflation. Imports in such countries are forecast to rise substantially as a result, although the general rise will be at a less rapid rate than following the 1973–1974 oil price increases.

Those countries that were experiencing financial constraints but have had these constraints lifted to a significant degree in 1979 include Algeria, Gabon, Indonesia, Nigeria, and Venezuela. All of these countries, with the exception of Gabon, recorded record current account deficits in 1978 and made significant recourse to borrowing to finance these deficits. The combined public sector external debt of this group of countries had risen to between $35 and $40 billion by the end of 1978, and Algeria's debt service ratio had risen above 20%. Indonesia, Nigeria, and Gabon had instituted policies designed to restrict imports and slow economic growth.

In 1979, however, the current account positions of all these countries are estimated to have improved quite substantially. The most spectacular reversal occurred in Nigeria, where a $3.8 billion deficit in 1978 is estimated to have become a $4.7 billion surplus in 1979. Similarly, Indonesia's $1.2 billion deficit turned to a surplus of $1.0 billion. While Algeria remained in deficit, the greatly increased export revenues of that country have lowered the debt service ratio and made the size of the debt less of a constraint on growth. As all of the countries in this group, with the exception of Gabon, have fairly large populations, it is expected that imports in 1980 will rise quite rapidly as a result of higher export revenues and improved current account positions.

In the Arab countries of the Gulf, two or three years of anti-inflationary policies, including slower growth in spending on development projects, have brought the rate of inflation down to tolerable levels. In Saudi Arabia, the consumer price index declined in 1978 and is not estimated to have increased very greatly in 1979. Government expenditures have thus increased more rapidly and this trend is forecast to continue, particularly in that mid-1980 will mark the beginning of a new five-year development plan. In the United Arab Emirates and Kuwait, the reduction in inflation has been less dramatic, but significant nonetheless.

The outlook for Iranian foreign trade is uncertain. Despite an expected further decline in average oil production in 1980, revenues should continue to rise as a result of higher prices. The unstable political situation is certain to keep imports at a much lower level than prior to the revolution, but some increase is still forecast from the very low level of 1979. Financial difficulties resulting from the freezing of a substantial portion of the country's external reserves by the United States in November, 1979, could inhibit the country's ability to import in the near term.

As a result of the rapid rise in imports forecast for OPEC in 1980, the rise in the merchandise trade surplus will be smaller than in 1979, although the rise in export revenues will be similar. The merchandise trade surplus is forecast at $129 billion, more than half again as large as the surplus recorded in 1974. Similarly, as a result of the smaller increase in the trade surplus and a continuation of the trend toward larger deficits on services, the current account surplus should not rise nearly as much in 1980 as in 1979. The aggregate current account surplus is forecast at $59.0 billion, a $10.8 billion increase from 1979.

It is interesting to note that Iraq is forecast to record the largest surplus in 1980, although data on Iraq's foreign trade are among the least reliable of OPEC countries and this forecast is, perhaps, less firm than those for most of the other countries. Saudi Arabia's forecast surplus, second only to that of Iraq, will return to the approximate level of 1975–1977, while Kuwait, the UAE, and Qatar, like Iraq, are forecast to record surpluses even larger than in 1974.

Only three countries are forecast to remain in deficit in 1980, compared to six in 1978. Algeria's ambitious industrialization and LNG-export plans will keep that country's import growth rate high, while Venezuela's deficit, although greatly reduced from 1978, is likely to remain for similar reasons. Ecuador, where oil consumption has been rising rapidly, is forecast to experience a revival of fairly rapid import growth following two years of slow growth.

Implications of the Surplus

The $107 billion combined surplus estimated for the two years, 1979 and 1980, will be approximately two thirds as large as the combined surplus of the previous five years. This large increase is occurring at a time when, not uncoincidentally, considerable volatility has been occurring in world financial markets and inflation in the industrialized countries is accelerating. In these circumstances, it is uncertain how the managers of OPEC funds will approach the problem of maintaining the real value of their assets.

Such evidence as exists presently indicates that the United States was seen as a less attractive place for investment by the OPEC countries in 1979 than at any other time in the past. The Bank of England estimates that OPEC countries actually disinvested in the United States during the first quarter of the year. The United Kingdom was seen as a more attractive place for OPEC funds at that time, while the rate of lending to less developed countries also accelerated. The first quarter figures may represent a lagged adjustment to the elimination of the OPEC surplus in 1978 rather than a lack of confidence in American investments, but developments later in 1979 would seem to indicate a strong preference for diversification away from dollar investments.

To the extent that this preference is acted upon, the strength of the dollar in 1980 discussed in the "Trade Trends and the U.S. Dollar" section may be moderated. The increased size of OPEC financial holdings once again raises the problem of increased instability in exchange markets, should these holdings be shifted to follow maximum return. Falling interest rates in the United States and continued high inflation do not augur well for continued OPEC holdings of the dollar. The alternatives, however, are not clear. Even if conditions appear more attractive in other areas, the size of the OPEC surpluses in 1979 and 1980 cannot easily be accommodated in other markets.

It has sometimes been proposed that a new instrument be devised and issued by the American government that would guarantee a real rate of return on OPEC funds invested in the United States. On the surface, there would seem to be no reason why anyone should be guaranteed a real return on an investment, and the political climate at present would seem to preclude the implementation of any such plan. The lack of a large enough market where an "adequate" real return can be received is, nevertheless, a strong argument for some of the countries with large surpluses to cut back on their oil production with further, unfortunate consequences for the world economy.

The solution to this dilemma appears to be principally in the economic policies of the industrial countries. Only through concerted efforts to reduce inflation and economize on the use of imported petroleum in the industrial countries—most importantly the United States—can the OPEC surplus countries be induced to maintain high levels of production over the next few years. Lack of such action will only prolong the unstable energy situation.

The Outlook for the Developing World

Sugarloaf Mountain, Rio De Janeiro

As the year began, expectations for the economies of developing countries not belonging to OPEC were relatively optimistic, as the anticipated U.S. recession was not expected, during the course of 1979, to become either as deep as in 1974–1975 or as geographically generalized. This view, in turn, supported forecasts that commodity prices would not deteriorate and that the growth of manufactured goods exports would not falter. Another important expectation was that the debt servicing abilities of the developing world would not be weakened to an extent that would undermine the confidence of lenders in the economic fundamentals or economic management of borrowing countries.

Events during 1979 have generally confirmed the anticipated favorable export performances of the non-OPEC developing countries, based, as expected, on commodity prices trends and strong growth in manufactured goods exports. The shallow pattern of the U.S.'s entry into recession was a main factor. An essential determinant of economic growth trends in much of the developing world is the degree to which various economies depend on their export

DEVELOPING WORLD ECONOMIC TRENDS

	Real Economic Growth			Aggregate Current Accounts		
	1978	1979	1980	1978	1979	1980
	(Percentage Change)			(Millions $ U.S.)		
Africa	2.9	3.5	3.0	-2,475	-3,000	-3,500
East Asia	9.6	9.0	7.0	-2,731	-6,000	-9,000
Latin America	4.3	5.3	4.8	-10,633	-14,000	-16,500
Mediterranean	4.7	4.9	4.0	-4,677	-6,500	-9,000
Middle East & North Africa	7.0	7.5	7.5	-3,433	-5,000	-8,000
South Asia	5.4	4.5	4.5	-1,917	-2,500	-4,000
All	5.2	5.7	4.7	-25,866	-37,000	-50,000

sectors and on the U.S. market. The U.S. market accounts for about 26% of the total market for non-OPEC developing country exports and about the same proportion of the market for the East Asian nations, but as much as 45% of Latin American exports. These two regions in turn produce the bulk of developing country exports—40.8% and 28.2%, respectively, last year. U.S. imports from developing countries expanded at a 19% rate during January through August 1979, compared to a 17.5% gain for 1978. Commodity prices, moreover, have been firmer than expected, having been boosted, in part, by increased speculative activity.

With the added factor of the continued flow of external capital into the non-OPEC developing world, economic growth rates also are estimated to have held up relatively well, as many such countries utilized foreign capital to attempt to thrust their economies into new growth phases. Mexico is, of course, a principal example, and, among others, the Philippines has also been undertaking large investment projects based on borrowings. In a sense, therefore, external borrowings during 1978 and most of 1979 were contributing to the larger current account deficits for many nations among this group, rather than the reverse of the process, which more nearly characterized the situation during the last major round of oil price increases during 1973–1974.

Even in advance of the oil price increases of 1979, therefore, the developing world was well on the road to a reversal in the narrowing trend in the current account positions of virtually all regional groupings of nations that had been in evidence since 1975. With the additional factor of higher oil prices, and with the spreading of the U.S. recession to West Germany, Japan, and other industrial countries as a capstone, the deterioration in the current accounts of this group of countries now appears to be sizeable, approaching 50%. The deficit, accordingly, will be nearly as large as the record 1975 figure. For 1980, another large deterioration will be seen, although the impact of the even higher average oil price hikes that are forecast will be partially offset by slower imports.

There are, nevertheless, many factors that argue that the problems faced by the developing world will be less damaging than those of the world recession of 1974–1975. The nations of the developing world have made a great deal of progress toward insulating their economies against external disruptions. They have, as examples, diversified and stimulated their export sectors, caused their external indebtedness to become less burdensome by restructuring portions of that debt, and progressed in the development of their own energy resources. Additionally, the shock to these economies from oil price factors does not promise to be as severe during the current round of price increases, given the approximate doubling of average oil prices between 1977 and 1980, compared to 300% price increases for oil[*] from 1973 to 1975.

Nevertheless, among the most serious of the implications of the oil and recession problems currently faced by developing countries is the new evidence that is offered that the process of fully insulating most such economies from external shocks is at the very early stage. The number of countries that will show trends counter to the general pattern illustrated in the table of slower real economic growth and weaker external positions will be small. For most developing countries, therefore, 1980 will be a year of problematic policy choices being made in a difficult external environment and, often in a less predictable domestic political environment.

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[*] Saudi Arabian

DEVELOPING WORLD EXPORTS
(Millions $ U.S.)

	1977	1978	Increase	Jan.-June 1979	Increase*
Africa	14,671	12,709	-13.4%	N.A.	N.A.
East Asia	53,586	65,911	23.0%	38,914	32.1%
Latin America	42,836	45,569	6.4%	26,103	14.8%
Mediterranean Countries	12,074	14,107	16.8%	N.A.	N.A.
Middle East & North Africa	13,518	15,130	11.9%	N.A.	N.A.
South Asia	7,642	7,934	3.8%	4,470	15.4%
Total	144,327	161,360	11.8%	92,796	20.8%

*From same months of 1978

1978–1979 Trends

The stimulus to economic growth derived from exports varied greatly from region to region last year, as suggested in the table, Developing World Exports. A major factor explaining the divergent impact of exports was the consumer-oriented tone of the economic expansion of 1978. The East Asian group led the way in export growth and enjoyed very rapid rates of economic expansion in doing so. Partial data on 1979 export trends for developing country regions indicate that export growth was even stronger in 1979.

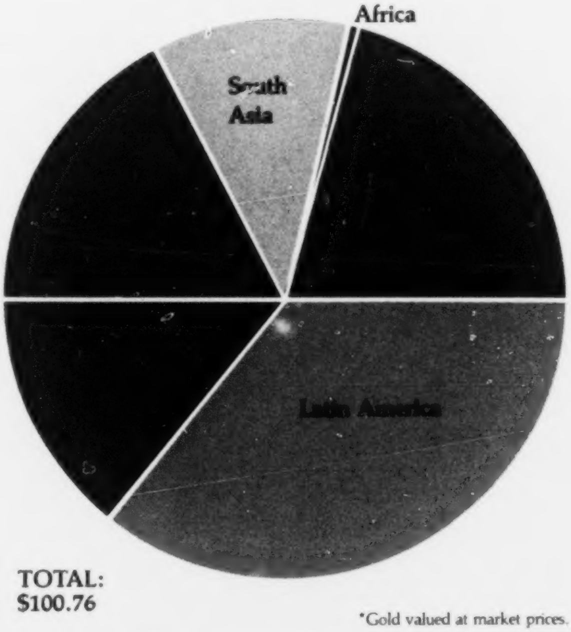
Manufactured goods exports continued to lead the way, as suggested in the partial year data for the countries that are the most significant developing country exporters of such goods. In the first months of 1979, for example, Taiwan's exports of manufactured goods rose 38.4%, and Hong Kong's 32.0%.

After lagging in 1978 due to price factors, commodity exporters also experienced more favorable market trends in 1979. In 1978, the IMF index of commodities most important to developing countries declined by 4.7%. In 1979 on the other hand, several important commodities reached post 1975 peaks, including aluminum, bananas, copper, beef, coconut oil, copra, rubber, and tin. The overall index also rose to a high for the recent period. The average of the first three quarters was, for example, 13.4% above the 1978 annual average.

Also fueling the relatively favorable growth performances of developing countries during 1979 has been the continued drawing of resources from abroad through external borrowings, chiefly Eurocurrency borrowings. Indeed, if trends through August continue through year-end, gross Eurocurrency bonds and credits seem likely to reach $33 billion, nearly $5 billion more than in 1978, although it is significant that the increase is substantially smaller than the 1977–1978 increase.

To some extent these borrowings resulted in the large accumulations of external reserves illustrated in the chart, Developing World International Reserves. From an economic growth standpoint, however, more important was the fact that the managers of the economies of such nations

DEVELOPING WORLD
INTERNATIONAL RESERVES—AUG. 1979*
($ U.S. Billions)



*Gold valued at market prices.

were turning their attentions to economic growth objectives, facilitating the influx of foreign capital into both the public and the private sectors of these economies. Mexico —by far the most active user of Eurocurrency credits over the past five years—is a leading example, borrowing $24.7 billion. Much of these external borrowings were invested in the development of Mexico's oil and gas resources, with favorable implications for economic growth and future debt servicing abilities.

It comes as no surprise, therefore, that even in advance of the new round of oil price increases beginning in 1979, imports by developing countries were rising, as shown in the table, Developing World Country Imports. The additional burden of oil price increases will clearly result in a much larger trade deficit for 1979. This is suggested in partial-year data, which shows imports rising during the first six months at a rate nearly double the 1978 full year increase.

In term of the current account, moreover, an upward swing in interest rates in 1979 has exacerbated the situation further, by adding to the debt servicing obligations of the developing world, a large portion of which is tied to a floating rate. The result is the estimated $11 billion slide in the aggregate current account position of all non-OPEC developing countries shown in the table, Developing World Economic Trends. Notably, however, in real terms the deficit remains substantially less significant than in 1975. The ratio of the aggregate developing world current account deficit is forecast to reach only 4.2% of the total developing world product, versus 5.7% in 1975. That ratio is, however, rising; it stood as low as 2.7% in 1978.

1980 Outlook

At this point, therefore, the outlook for the bulk of the nations of the developing world is for the least favorable performance since 1975. Regional variances will be explainable partly by such factors as the extent individual developing countries depend on exports, particularly of manufactured goods. The nations of East Asia, the principal beneficiaries of the recent world up-cycle, therefore, will be strongly affected. Commodity exporters also will suffer the effects of a downturn in world prices from 1979's peaks.

Perhaps the telling factor, however, will be the positions of various countries with respect to petroleum, summarized on a regional basis in the table, Developing World Petroleum Trends.

The impact of oil will vary greatly. It should not be overlooked, for example, that more than a dozen developing nations not belonging to OPEC are net exporters, including Bahrain, Egypt, Malaysia, Mexico, Oman, Peru, and Zaire. Numerous others are nearly self-sufficient. By next year the Middle-East and North-African group will be a net exporter of oil and the entire developing world and its various regions are making progress toward greater self-sufficiency.

Nevertheless, for the short run, the recent increases in oil prices, and possible further increases, are considerable shocks that many developing countries will be able to absorb only with some difficulty. As examples of the varying impact of oil on individual countries, including both exporters of oil and countries with serious deficits, the outlooks of the five heaviest users of Eurocurrency credits are shown at the end of this section. In total, moreover, and for most regions, oil will be the factor most telling in the large current account deficits and slowed growth illustrated by the table, Developing World Economic Trends, rather than the world recession.

It is also important to note, when considering the outlooks of individual countries that the problems associated with higher oil bills and slower growth suggests policy

DEVELOPING WORLD IMPORTS
(Millions $ U.S.)

	1977	1978	Increase	Jan.-June 1979	Increase*
Africa	15,540	16,801	8.1%	N.A.	N.A.
East Asia	57,233	73,334	28.1%	44,894	33.8%
Latin America	49,086	54,603	11.2%	33,783	27.6%
Mediterranean Countries	27,751	27,659	-.3%	N.A.	N.A.
Middle East & North Africa	29,146	34,703	19.1%	N.A.	N.A.
South Asia	8,702	10,113	16.2%	5,483	16.2%
All	187,458	217.213	15.9%	133,831	30.3%

*From same months of 1978

GROSS EUROCURRENCY CREDITS AND BONDS
(Millions $ U.S.)

	1975	1976	1977	1978	1979^E
Africa	258	240	441	418	900
East Asia	1,727	3,087	2,963	6,343	8,000
Latin America	5,804	8,110	9,336	17,421	19,000
Mediterranean Countries	516	750	1,030	2,258	4,100
Middle East & North Africa	630	995	1,762	1,684	900
South Asia	—	—	50	55	100
Total	8,935	13,182	15,582	28,179	33,000
Total Publicized Euro-Currency Credits and Bonds	43,375	63,014	70,280	108,676	113,000
Developing Country Share	20.6%	20.9%	22.2%	26.0%	29.2%

Sources: World Bank, OECD, SPNB Estimates E = Estimate

responses which typically are based on restraint. To a great degree, however, the maintenance of respectable rates of economic progress has taken on a higher priority throughout the developing world, especially given the implications of such progress for the maintenance of political peace. The significant developments liberalizing the political process seen in several developing nations, hence, also have implications for economic policy and the success authorities in these countries will experience in meeting the challenges of 1980.

Developing World External Debt

The total external debt of the regions examined in this analysis was approximately $160 billion at the end of 1977, according to figures recently published by the World Bank. The 24% increase estimated by that institution for 1978 would push the total to around $200 billion, whereas a similar increase for this year would indicate that that debt will stand at around $240 billion at present. Debt totals for various regions are shown in the Developing World External Public Debts, table, which also suggests the rising significance of the debt in real terms—illustrated by the ratio of the debt to gross national product.

In addition, private sector debt is estimated at $44.2 billion in 1977, growing to $50 billion in 1978, and on the order of $60 billion by year-end 1979. For next year, given

DEVELOPING WORLD PETROLEUM TRENDS
(000s b/d)

	Production			Consumption			Exports			Imports			Ratio M-X/C		
	'78	'79	'80	'78	'79	'80	'78	'79	'80	'78	'79	'80	'78	'79	'80
Africa	215	220	225	480	490	500	185	190	200	450	460	475	55.2	55.1	55.0
East Asia	460	495	530	1,600	1,650	1,700	305	325	355	1,440	1,485	1,525	70.9	70.3	68.8
Latin America	2,400	2,900	3,300	3,300	3,500	3,700	550	900	1,150	1,450	1,500	27.3	17.1	9.2	
Mediterranean	135	150	160	1,050	1,100	1,150	—	—	—	915	950	990	87.1	86.3	86.1
Middle East & North Africa	1,150	1,260	1,420	1,225	1,285	1,350	790	860	990	865	885	920	6.1	1.9	5.2
South Asia	250	265	285	610	650	700	—	—	—	360	385	415	59.0	59.2	59.3
Total	4,610	5,290	6,020	8,265	8,675	8,900	1,830	2,275	2,695	5,480	5,665	5,875	44.2	39.1	35.7

DEVELOPING WORLD EXTERNAL PUBLIC DEBT
(Millions $ U.S.)

	1977	1978	1979
Africa	$ 17,412	$ 20,000	$ 23,000
East Asia	18,588	28,000	37,000
Latin America	62,809	83,000	100,500
Mediterranean	11,451	13,500	16,500
Middle East & North Africa	31,385	34,000	38,000
South Asia	18,171	21,500	25,000
Total	159,816	200,000	240,000
Percent Total GNP	18.9%	21.0%	22.3%

the assumed large deterioration on the aggregate current account positions of these nations, further large increases in debt are anticipated.

Of particular significance in these totals is the proportion of the debt owed to international financial institutions. Such debt is generally on terms less favorable to developing countries than the interest rates and tenures that are applied to loans from multilateral institutions and government lenders. The total of such loans is estimated to represent up to 37% of the disbursed public sector debt and virtually all the outstanding private debt, plus substantial amounts of short term debts.

Debt servicing obligations have been growing at a pace outdistancing the growth of the debt, given the shift towards the larger role of international financial institutions. Total debt servicing payments in 1977 for these countries were about $22 billion, including $14 billion in amortizations and $9 billion in interest. Figures for 1978 have not yet been published.

A "world public sector debt service ratio" (servicing payments divided by goods and services earnings) was, according to recently published figures for 1977, approximately 11.6%. The ratio for 1978 was about 13%. This year the ratio will rise once again, given declining rates of growth of exports and rising servicing payments, the latter being exacerbated by the high interest rates which prevail in the U.S. and elsewhere. This factor may, however, lessen the rate of the climb in debt servicing obligations next year, as major interest rates decline from late 1979 and early 1980 peaks. The most favorable trend which can reasonably be anticipated, however, given projected slower growth of exports next year, is a leveling in the debt service ratio in the high teens rather than a decline to the situation of 1977-1978.

Individual country experiences with the problem of debt and debt servicing will, of course, vary widely over the coming year. The quality of national economic management, moreover, seems likely to remain the key to these variances. The focus of such management should appropriately be on the fuller development of the potential present in the economies of the developing world for increasing national savings and generating higher foreign exchange earnings. For most such nations, nevertheless, success in such efforts probably would only moderate, rather than replace, the need for even greater importation of capital, if recent rates of capital information and growth are to be maintained.

Representative Country Outlook

The foregoing analyses dealt mainly with the performances and outlooks of main developing world regions. Following are very brief outlooks for five important countries—Argentina, Brazil, Korea, Mexico, and the Philippines—which over the past few years have been disproportionately heavy users of external borrowings in terms of their GNP or export totals. Collectively, for example, these five accounted for 66% of publicized Eurocurrency borrowings from 1975 through 1979, whereas their collective contribution to developing world exports is only about 25% and their share of devloping world GNP's 38%. Among the factors common to these countries that facilitated their heavy drawing of external savings were, first, confidence among lenders in the economic fundamentals, often meaning their resource base, and, second, lender confidence in the quality of the management of these economies.

For the near term the outlooks of these countries diverge greatly, mainly on the basis of oil and market factors.

Argentina

Since 1976 Argentine authorities have been exerting great efforts to eliminate the distortions created by decades of political waverings and economic mismanagement. The roles of the private and public sectors were redefined, foreign investment encouraged, and efforts intensified to eliminate the deficits in the nation's budgetary and external accounts.

The greatest success has been the external sector. Because of changes in the legal basis of the agricultural trade and favorable world market conditions, the turnaround has been dramatic. The current account has shown a surplus for four consecutive years, over $2 billion last year, and external reserves have surpassed $9 billion.

It is proving to be much more difficult, however, to find solutions to the problem of inflation, which remains unacceptably high. Measures to revitalize the domestic economy, therefore, have had to be delayed, as authorities have sought to find a key to such a solution, which is still seen by them in fundamental terms, i.e., increasing the competitiveness of industry through tariff changes, eliminating the budget deficit, and stimulating the private sector to play the leading economic role. Economic growth, therefore, has shown a very irregular pattern. Negative growth was recorded for 1976, followed by a recovery in 1977, and another negative year in 1978, as authorities intensified their struggle against inflation. Growth has rebounded strongly in 1979, but sustained progress is still threatened by inflation.

The key to the flow of external savings into the volatile Argentine situation is seen as the the commitment of the authorites to their fundamental goals, which in turn are perceived as appropriately framed. Argentina, importantly, is not as threatened by the short run cyclical developments as certain other nations, due to its near self-sufficiency in petroleum. That factor, Argentina's endowment with other resources, its agricultural strength, and its rich, diversified economy are the main bases of optimism for the long run. Argentina, therefore, will probably remain at the forefront of the ranks of nations that are active in international financial markets, especially since—due mainly to the long period ending in 1976 during which Argentina was not an attractive borrower, the burden of the nation's debt remains low.

Brazil

Brazil is the developing nation on which changing world oil prices will have the greatest impact. Brazil consumes about 12.5% of all the oil consumed by the developing world and imports above 80% of its consumption. The nation's oil bill has been estimated at $7 billion for this year and it could be as high as $10 billion next year, depending on whether further price increases are forthcoming, as assumed in this forecast. Additionally, Brazil is very unfavorably affected by rising interest rates, given its total public and private sector foreign debt of about $50 billion by year-end. While exports are still growing rapidly, a current account deficit of more than $9 billion is estimated, the highest ever, although in real terms the burden is considerably less than in 1974 and 1975. The current account deficit was equivalent to 96% of Brazil's exports and 7.2% of its GNP in 1974, versus about 60% and 4.5%, respectively, in 1979. Brazil will finance this deficit, as well as the $6.2 billion in amortization payments due this year, partly by drawing down reserves, but mostly by new capital inflows, including new debt.

The short run, therefore clearly holds many difficulties for Brazil, not only because of oil, but also because of the projected world recession next year, which could hold down export growth. Inflation is also intensifying, threatening a key strategy in resolving Brazil's trade problems next year—greater stimulation of exports, particularly of agricultural goods.

Brazilian economic policy turned somewhat in August with the changing of finance ministers. The previous minister was following a politically unpopular and not-fully-effective policy of monetary and fiscal restraint. The return of Delfin Neto, a previous finance minister who is credited as the author of the "Brazilian miracle," infused new optimism into the situation, although circumstances may dictate that Neto will, in effect, have to continue restraining policies. The keys to the short run will be weather (because of its impact on agricultural exports), conditions in foreign markets, possible deteriorations in the terms and conditions and/or availability of foreign capital, and whether inflation, in fact, can be brought under control in a way that will not provoke excessive unemployment.

South Korea

South Korea's economy is slowing currently. On policy grounds the government considers the 1978 real economic growth rate of 11.8% to have been excessively inflationary. Growth targets have been revised downward, and additionally, the U.S. recession will have a significant impact on Korea, given the fact that 28% of Korea's GNP is produced by exports, whereas 30% of exports go to the U.S. market. Real economic growth probably will run at about 8% this year , with a further slight decline to the 7–8% range in 1980. Inflation, nevertheless, seems likely to pickup from last year's 14.3% increase in consumer prices to about 20% with higher oil and other import prices replacing domestic demand pressures.

The impact of higher oil prices and recession on South Korea's current account position may to some extent be offset by the expected slower growth rate and an ending of the policy of encouraging imports to help slow the growth rate, a part of recent economic strategies. It seems unlikely, however, that formal import controls will be reinstituted. Nevertheless, price factors alone indicate an approximate $800 million increase in the import bill, with another large increase coming next year. Most of the offset of slower non-oil import growth on the higher oil bill will be seen in 1980. For 1979 a $3.5 billion deficit is likely. For 1980 that number

Coffee plantation, Sao Paulo, Brazil

has been officially forecast to rise to $4.5 billion.

These expectations in fact demonstrate that South Korea is relatively well placed for coping with cyclical problems arising from oil price increases, being—in spite of its total dependence on imports—one of the world's four non-oil developing countries that are dependent on petroleum for less than 50% of total energy needs.* Additionally, the same factors encourage expectations of success in longer run economic strategies. The Korean economy has to date been relatively labor intensive and based on a lower level technology, but authorities are attempting to change to a more capital intensive, higher technology base, a move which Taiwan and Singapore are also making. This shift, which has become an important factor stimulating Korea's increased borrowing in international financial markets, was prompted by the views of Korea's planners that the economic development of China and other lower-income Asian countries will soon offer increased competition in export markets that are the mainstays of Korea's economy. Given Korea's increasing labor costs, authorities are attempting to make the move earlier when a greater degree of economic planning will be possible.

Mexico

At the opposite end of the scale from Brazil—as far as the impact of oil prices is concerned—is Mexico, soon to be the world's largest non-OPEC oil exporter. The 1979 growth rate should be sharply higher than 1978's 6.6% and 1980's higher still. A large-scale industrial development plan was announced recently, programming huge amounts of public sector investment—drawn from oil and gas imports—and providing strong incentives for private sector investment. If successful, growth would be boosted to an average of 10% in the 1980's, and one of Mexico's main socio/economic problems—lagging job creation—would be significantly eased.

Oil earnings seem likely to double in 1979 from 1978's $1.8 billion and perhaps double again the following year. Natural gas exports will also begin in the near future, now that an agreement with the U.S. has finally been concluded. For this year, nevertheless, an increase in the current account deficit to around $3 billion, compared to 1978's $2.4 billion, is anticipated, due to an extremely rapid import growth, 45% in the first six months. Next year, following

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*The others are India, Pakistan and Zambia.

PERFORADORA
MEXICO
S.A.

Mexico—Soon to be the world's largest non-OPEC oil exporter.

the completion of several large investment projects connected with the development of the oil and gas sector, import growth should slacken, and Mexico will see its current account deficit begin to decline on fundamental grounds to about the 1978 figure.

Another problem which will benefit significantly from the growth of the oil and gas exports will be that of the external debt. Mexico remains the leading developing-country borrower in the Eurocurrency market, borrowing approximately $25 billion, gross, during the last five years. The debt service ratio on the public sector outstanding debt was 61% for 1978, easily the world's highest. Although the ratio climbed again in the first six months of 1979, the trend can be predicted to be reversed in the near future, due to the rise in export earnings. For the future, moreover, resort to external credit will be lessened not only by rising governmental receipts from oil but also since PEMEX has nearly arrived at the stage of being self financing.

One remaining concern Mexican authorities had found difficult to solve is that of inflation. The tremendous injection of earned and borrowed liquidity into the economy has been a major factor. Despite some efforts earlier in 1979 to cool some of buoyancy in the economy, inflation has been running ahead of last year's 17.5% pace. In Mexico's new economic era inflation seems likely to be a more difficult to control problem for the nation's economic managers, who otherwise have been successfully attacking other formidable problems.

The Philippines

Growth in the Philippines for 1979 should be in a range near 1978's 5.8%, but should decline moderately next year, given the slower growth rates forecast for industrial countries. The deterioration in the current account will also probably be relatively modest, from a deficit of about $1.2 billion to one of $1.7 billion, with some improvement being foreseen for 1980, due to slow domestic growth. Increased oil output at the Nido site will partially offset the impact of world oil price factors for this year, although maximum output levels have been reached, and the Philippines will feel the full impact of oil price factors in 1980.

In addition to lagging rates of real economic growth inflation has become a serious problem in the Philippines. Domestic liquidity pressures were a factor in the 7.6% rise in the CPI in 1978 and oil prices have exacerbated the situation in 1979. A 25% increase in consumer prices is foreseen for 1979, with only a moderate decline to 15–18% being considered possible for 1980.

It appears from partial data that the Philippines' agreement with the IMF that foreign borrowings be held to certain maximums over the period 1978 through 1981 may have been exceeded. In addition, new packaging is being used in external borrowings, to which IMF guidelines do not apply. In these respects, however, there is some suggestion that the heavy borrowing by governmental agencies that has been taking place represented some *de facto* rescheduling to improve debt repayment profiles and obtain lower interest rates.

For the future, the Philippines' participation in external financial dealings will be affected, first, by the fact that the Philippines' debt-servicing burden is objectively small, with a public sector debt service ratio of 13.7% for 1978, although it is increasing. Secondly, the nation's needs for increased investment and are tremendous.

Current infrastructure spending on roads, energy production and distribution, etc., are fundamentally important. Furthermore the emphasis on diversifying the economy so that foreign exchange earnings are not dependent overwhelmingly on a few products seems appropriate. How successful this program will be is difficult to say; the signs indicate a reasonable degree of success to date.

Trade Trends and the U.S. Dollar

Foreign Exchange and Eurodollar trading room—Security Pacific National Bank, Los Angeles

In 1979, trends have been established for world trade, the U.S. current account, and the international value of the U.S. dollar, all of which should continue through a major portion of 1980. The level of world trade should show signs of growing more slowly by the end of 1979, and this trend should extend through most of 1980. The U.S. has experienced a marked decline in its current-account deficit during 1979 and should see a small surplus in 1980. Finally, the U.S. dollar in 1979 has generally strengthened in comparison to 1978 and should continue to strengthen very modestly during the first three quarters of 1980, thus avoiding any precipitous declines as occurred during 1978.

A GLOBAL VIEW OF TRADE

The growth in the physical volume of international trade and the rate of the world's real economic growth bear a positive relation to each other. As the rate of real economic growth increases, the rate of growth of the physical volume of trade (i.e., trade in constant dollars) increases. Empirical evidence for this phenomenon is more difficult to show on a world level than on a national level, because of the problems involved in calculating a real economic growth rate for the world. On a national level, however, investigations have clearly proven this relationship.

The consequences of this relationship can be seen in the chart which depicts the annual percentage change in world trade in both nominal terms (in current dollars) and in real terms (in constant dollars) from 1973 through 1978, with forecasts for 1979 and 1980. For example, in 1974 the noncommunist world's real trade as measured by imports grew 3.5% from one year earlier. At the same time, nominal trade ballooned 46.5 %. This large increase in nominal trade was, to a large extent, the result of the quadrupling of oil prices. Import prices rose about 42% in 1974 over 1973 levels.

Then in 1975, most of the world's economies experienced significant slowdowns in their growth; many underwent outright recessions, in that real economic growth was negative. The decline in growth resulted, in part, from the economic disruptions ensuing from the oil price rises occurring during late 1973 and 1974. Because of the drastically reduced rates of real economic growth, international trade displayed distinctly reduced rates of growth. In fact, real trade declined absolutely by 4.6%, whereas nominal trade grew by a small 3.7%.

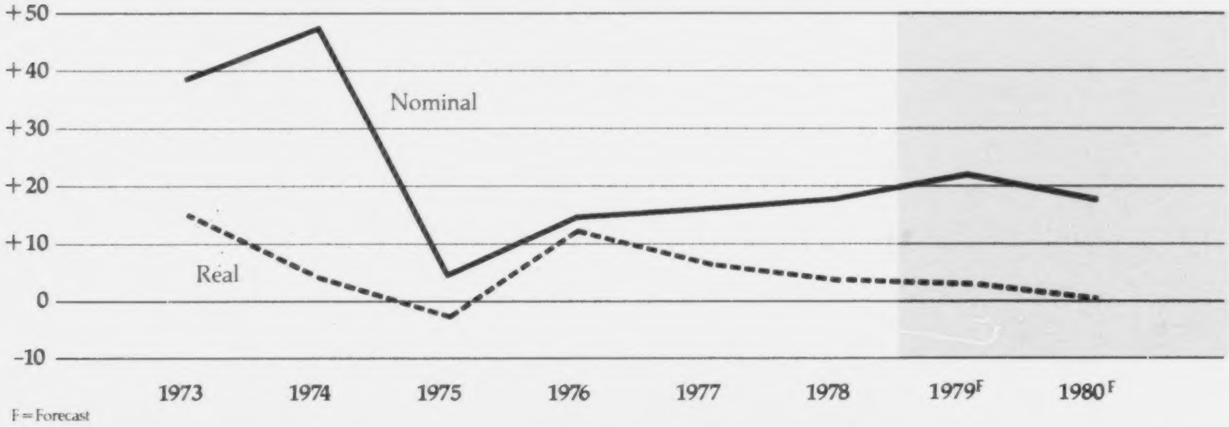
What this relationship indicates for 1979 and 1980 is that the world's trade, measured in constant dollars, is expected to show signs of growing more slowly by the end of 1979 and will drop off sharply in 1980, although it should remain positive. An examination of the projected growth rates for the noncommunist world's major economies provides the basis for these conclusions.

The U.S. economy, after growing 4.4% in real terms in 1978, is expected to slow down, according to SPNB's forecast, to a 2.0% real growth rate in 1979, whereas economic output in 1980 is anticipated to decline 2.0%. Thus, the recession in the U.S. will be approximately half as severe as that of 1973-1975. Germany's real economic growth rate, which was 3.5% in 1978, is expected to have increased to 3.8% in 1979, but it should be just about halved to 2.0% in 1980. The United Kingdom's real economic growth rate, on the other hand, is estimated to have fallen sharply already in 1979, to 1.0% from 3.2% in 1978. Another substantial decline is anticipated for 1980, with a negative real economic growth rate of 1.5% forecast. The Japanese economic growth rate for 1979 is estimated to be 5.3%, following a 5.6% growth in 1978. Real economic growth in 1980 is forecast to fall about 28%, to 3.8%.

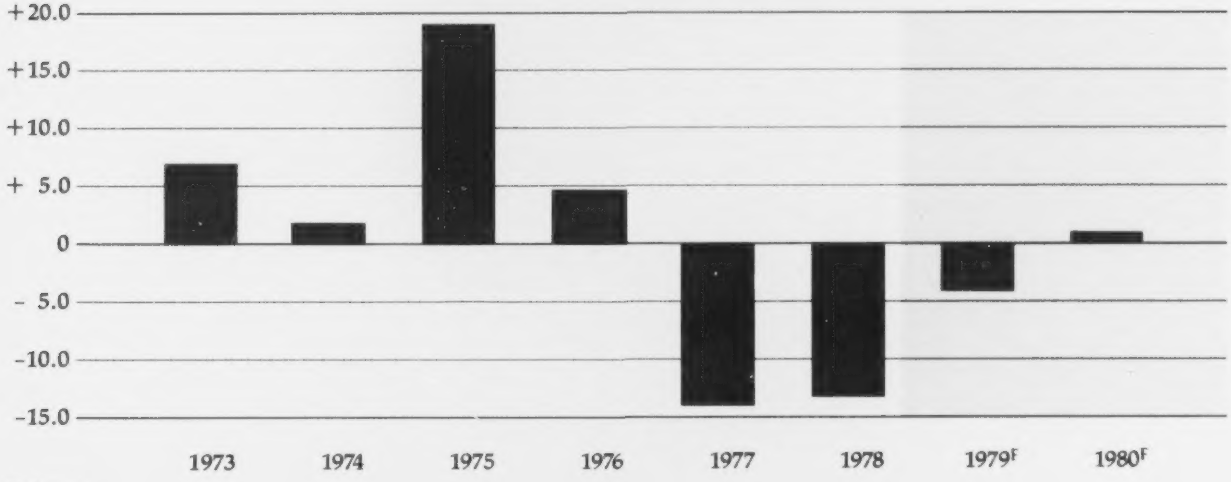
The reduced rates of growth for the above countries are reflected in the overall growth rate for the OECD (Organization for Economic Cooperation and Development), which is composed of twenty-four industrialized nations. For the OECD as a whole, real growth in 1978 was 3.9%. Real growth is anticipated to decline to 2.9% in 1979 and to fall even further in 1980, to 0.5%. The OECD economies account for more than three fourths of the noncommunist world's output and over half of its trade. Hence, a significant slowdown in economic growth for the OECD would imply a distinct decline in the level of international trade.

The general economic slowdown during 1980 looks to be less severe than the one in 1975. By way of comparison, the real economic growth rate in 1975 for the U.S. was -1.3%; West Germany, -1.9%; the U.K., -1.7%; and Japan, a positive 1.4%. This generally negative growth situation led to a 4.6% decline in the level of real trade. Our forecast indicates

PERCENTAGE CHANGES IN REAL & NOMINAL WORLD TRADE 1973-1980



U.S. CURRENT ACCOUNT BALANCES 1973-1980
(Billions of U.S. Dollars)



F = Forecast

that real economic growth will be considerably lower in 1980 in comparison to 1979, but it will be positive instead of negative as in 1975.

On the other hand, the noncommunist world's trade in nominal terms can be expected to continue to grow due to oil price hikes occurring since December of 1978. We are assuming that on a year-over-year basis oil prices will have risen almost 37% in 1979 and an even larger 45% in 1980. And although oil shipments account for only about 13% of the noncommunist world's trade, these price rises will affect the price of most other goods, in view of oil's pervasive use.

Given our economic outlook for 1979 and 1980, world trade in real terms is forecast to grow by a reduced 3 to 4% in 1979 and 0 to 1% in 1980. In nominal terms, however, the increase in the value of world trade will show substantial growth for both 1979 and 1980. Assuming a 36.9% increase in oil prices and a 14% increase in the prices of other imports in 1979, the average price of would imports should rise about 17.0%. During 1980, with oil prices expected to rise in the neighborhood of 45% and other export prices expected to rise at a somewhat slower rate than during 1979, world export prices on average should increase approximately 16.5%. Given our assumed real export growth rate of 4% in 1979 and little, if any, in 1980, world exports in nominal terms should increase about 21% in 1979 and approximately 17% in 1980. These percentages imply that world exports should total approximately U.S. $1,500 billion in 1979—an increase of $266 billion from 1978, and about $1,740 billion in 1980.

U.S. TRADE AND CURRENT ACCOUNT

Submerged under all the talk about the tardy U.S. recession and the continuing struggle against inflation is the good, if not splendid, news concerning the significantly improved U.S. current account position in 1979 and 1980. It now looks as if the U.S. will experience a reduction in the deficit in the current account from $13.9 billion in 1978 to $4 billion in 1979. Moreover, SPNB forecasts that in 1980 the U.S. current account should post a surplus of $0 to $2 billion, the first surplus since 1976, as is shown in the accompanying chart.

The improvement in the current account position, which includes all imports and exports of both goods and services, is reflected in smaller deficits for the merchandise trade balance and larger surpluses for services, or the so-called "invisibles," for both 1979 and 1980.

The merchandise trade deficit in 1979 is forecast to shrink to $23 billion on a custom's value basis from $28.4 billion in 1978. On a balance-of-payments basis, the trade balance should be $28 billion in 1979, a decline from the $34.2 billion deficit posted in 1978. This sizable reduction is due primarily to the differential rates of economic growth between the U.S. and her major trading partners.

U.S. economic output is forecast by SPNB to grow at a reduced 2.0% during 1979 in comparison with 1978, with positive growth in the first and third quarters (1.1 and 2.4%, respectively, at an annual rate) and negative growth in the second and fourth quarters (-2.3 and -1.3%). Simultaneously, most of the world's major industrialized economies are growing more rapidly than during 1979 in comparison with the U.S. The moderating U.S. growth has brought about a decline in U.S. import growth, whereas the relatively strong economic growth elsewhere has provided an excellent export market for the U.S.

By way of comparison, in 1978, the U.S. economy performed better than anticipated, posting a 4.4% real growth rate. Other economies were generally sluggish. The OECD excluding the U.S. recorded real growth of 3.6% in 1978. In 1979 growth will decline very marginally, to 3.5%, whereas economic growth in the U.S. will have dropped by over half.

Hence, due to vigorous import demand overseas, U.S. merchandise exports are forecast to grow between 22 and 23% in 1979, to $176 billion from $143.6 billion in 1978. Concurrently, U.S. imports are expected to grow about 16% to $199 billion from $172.0 billion in 1978 on a custom's value basis ($204 billion on a balance-of-payments basis). Thus, largely because of the differential rates of economic growth between the U.S. and other economies, a merchandise-trade deficit of $23 billion on a custom's value basis, or $28 billion on a balance-of-payments basis, is seen for 1979.

Partially offsetting the deficit on merchandise trade is the growth in net earnings on services which has increased very strongly during 1979. Net income from foreign investment is, as of the first half of 1979, running more than 41% over levels from the first half of 1978 and about 24% over levels for the second half of 1978. Hence, the U.S. should earn a net surplus on this item in the neighborhood of $27 billion in 1979. When added to the approximately $3 billion deficit from the other entries in the services or invisibles account, a $24 billion surplus on services payments results. This calculation results, on a balance-of-payments basis, in a $4 billion deficit on the current account for 1979, when added to the $28 billion deficit on the merchandise-trade account.

The current account for the U.S. in 1980, just as in 1979, will be influenced to a major degree, by the real economic growth rates registered in the U.S. and elsewhere. SPNB's forecast calls for the U.S. economy to decline through the first three quarters of the year and grow only in the fourth quarter, as discussed more completely in the section on the U.S. outlook. For the year as a whole, output in constant dollars is forecast to decline 2.0% from 1979's total. The recession in the U.S. will result in a further slowdown of U.S. merchandise import growth from 16.0% in 1979 to 11.5% in 1980. Thus, merchandise imports in 1980 should total $222 billion ($227.5 billion on a balance-of-payments basis), an increase of $23 billion composed totally of price rises. A major factor keeping merchandise imports from falling is the almost 45% rise in oil prices predicted for 1980.

Although our major trading partners will also be experiencing lower real economic growth rates during 1980, theirs will still be positive (except for the U.K's 1.5% decline). The OECD excluding the U.S. is expected to expand only 2.0% in 1980 in comparison with 3.5% in 1979. Furthermore, the Japanese and developing nations, which comprise a major share of the U.S. export market, will probably be growing more strongly than other major industrialized economies in 1980. Hence, U.S. merchandise export growth may decline somewhat less. For the year, we forecast exports to increase by approximately 15%—about one-third less than during 1979—to $203.5 billion.

As a result, the merchandise-trade deficit in 1980 should be about $19.5 billion on the widely-watched custom's value basis, a decline from the $23 billion deficit in 1979. On a balance-of-payments basis, the deficit would be approximately $25 billion, $3 billion less than for 1979.

The SPNB forecast calls for only a modest improvement in the surplus on net earnings from the services account, to $26 billion during 1980, an increase of $2 billion from 1979's surplus. Hence the current account in 1980 should register a surplus of $0 to $2 billion. This figure is considerably lower than the $10 billion surplus on the current account forecast by the government and the $5 billion surplus foreseen by many other institutions. We feel, however, that oil price rises will be greater and export earnings, less. Thus, their optimistic forecasts are likely to be scaled down as the year progresses.

If the oil price rises had not been as large as they have been in 1979 and will probably be in 1980, the U.S. would have likely registered a small current account surplus in 1979 and a $10 billion or more surplus in 1980. These results would have much more closely resembled the dramatic change in 1975, when the U.S. current account went from a surplus of $2.1 billion in 1974 to an $18.4 billion surplus a year later.

Although this forecast for the U.S. current account is welcome news, it is of relatively short-run importance. A significant, long-term improvement in the U.S. current account position would require an increase in the level of U.S. productivity from its currently dismal state and other factors, such as lowering the rate of inflation. Our ability to deal effectively with these issues will influence our role in the world.

OUTLOOK FOR THE DOLLAR

Trends during 1978–1979

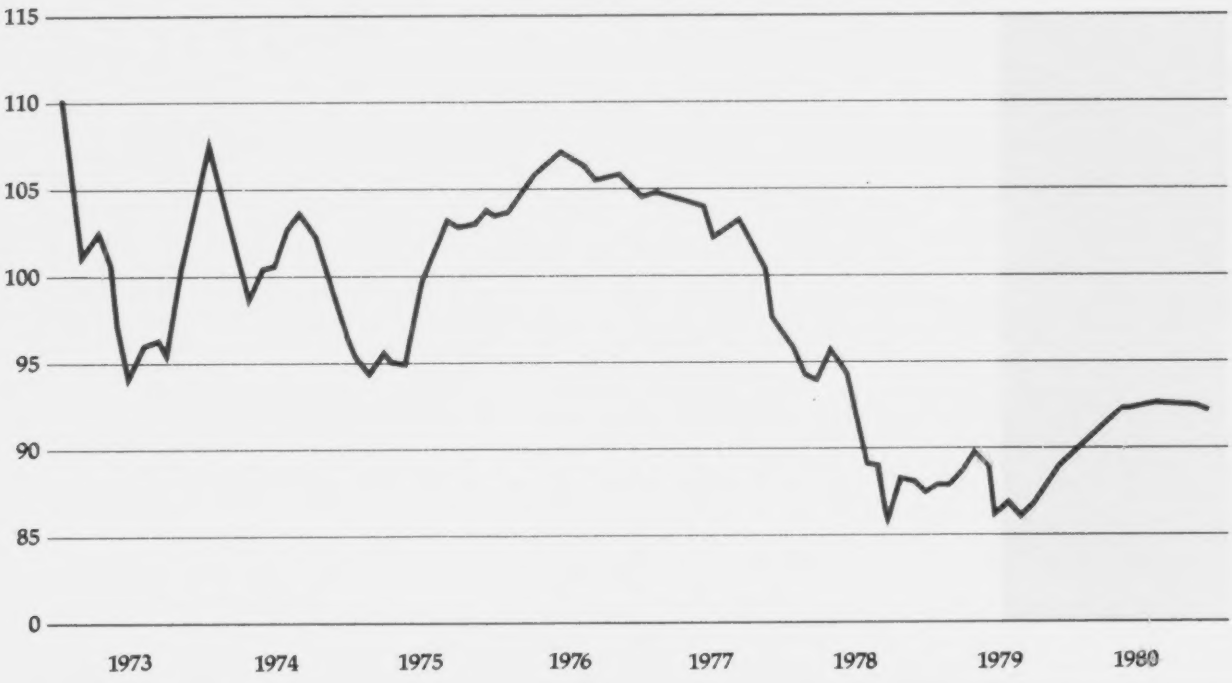
The precipitous decline of the value of the dollar versus other major currencies through most of 1978 was the result of unfavorable cyclical factors, negative fundamental trends, and, in retrospect, inappropriate external policy choices by U.S. financial and monetary authorities. The nation's well-documented economic problems were centered on a deteriorating trade position and accelerating inflation. One of the great lessons of 1978 was that the downward movement of the dollar—at least in the short run—produced little improvement in the U.S. trade position. Possibly one of the most significant events of the year

The outlook for the dollar is tied to inflation/oil developments.

was the recognition of this fact implied in the November defense package introduced by the Federal Reserve Board and the Administration. This move represented a philosophical shift toward defending the dollar, rather than the previous approach of "talking the dollar down," which had been based on the assumption that exchange rate movements would act as a corrective mechanism.

Hence, the year 1979 began with new, supportive Fed policies concerning the dollar. Early in the year, moreover, the cyclical factors began to favor a stronger dollar as U.S. economic growth softened relative to our trading partners. The result was an improvement in the U.S. trade and current account positions. Beyond that trend, short-term capital flows swung toward the U.S., as interest rates moved upward. Finally, long-term captital flows began to move more strongly into this country, underpinning, along with the trade improvement and interest responsive short-term flows, improvement in the trade-weighted dollar shown in the chart, Trade-Weighted Exchange Rate for U.S.$.

While economic factors such as these were strengthening the value of the dollar toward the mid portion of the year, uncertainties concerning Middle East developments, higher oil prices, and the inability of the Administration to control inflation began to swing speculative sentiment against the dollar once again. Such was particularly the case vis-a-vis the European currencies. The oil equation continues to be one that is particularly difficult to read in terms of its impact on the dollar. At times, higher oil prices have been viewed as being less ominous for the U.S. because of the nation's lesser dependence on imported oil, compared with most other industrialized nations, and because of the presumed U.S. potential for conservation. Additionally, as far as the dollar is concerned, a positive factor is that the higher oil prices require other nations to obtain larger amounts of dollars to meet their oil bills. Nevertheless, in the end, the events of mid 1979 turned out to represent a basically anti-dollar episode, due mainly to a turn in market psychology which began to read ongoing factors in a more negative light. The most pessimism arose from the inability of the U.S. to come to grips with a growing dependence on imported oil. The resultant downward drift of the dollar versus other key currencies—with the exception of the yen—was a significant



TRADE-WEIGHTED AVERAGE EXCHANGE RATE FOR U.S. DOLLAR
(Index: March 1973 = 100)

factor in the decision to launch another Federal Reserve Board support package on October 6. Included were moves to raise the discount rate from 11% to 12%, to impose an additional 8% reserve requirement on certain liabilities, to place more emphasis on targeting bank reserves and the money supply, and to place less emphasis on targeting interest rates. The package had two dramatic effects. One was to raise interest rates and the other was to increase the drag on the U.S. economy, elongating the decline which had already begun. The actions, therefore, had beneficial effects on the U.S. trade and current account outlooks and some favorable implications for, at least, demand-pull inflationary pressures. Such trends as these notwithstanding, however, as the year draws to a close, market psychology—specifically Middle East problems—is at times transcending economic fundamentals, producing a situation for the dollar that is very difficult to read, despite basically favorable underlying trends.

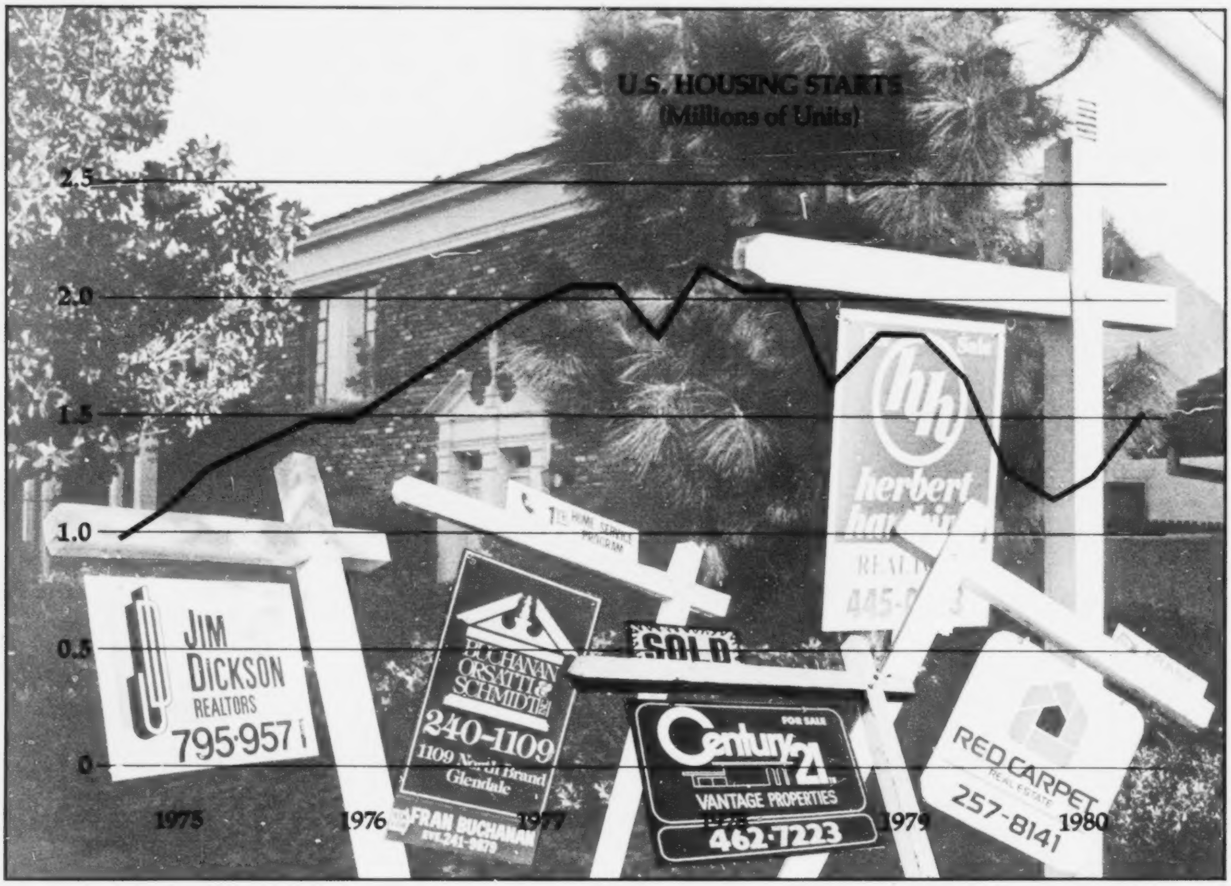
1980 Forecast

The elongation of the forecasted U.S. economic decline implies a longer period of strength for the dollar. A sizable improvement is anticipated in the U.S. current account position, to a surplus of up to $2 billion, after a $4 billion deficit in 1979. As indicated, however, the implications of this trend for the dollar are tempered by the oil price implications of the Iranian situation.

Therefore, the forecast strength of the dollar through much of 1980 is based upon an unfolding of the situation in the Middle East that includes short-run disruption, but not long-term disasters that would fundamentally affect oil supplies. An alternative assumption—one that is based on a explosion in the Middle East—would produce a much more volatile forecast, which, in the current world context, would include downside pressures on the dollar, notwithstanding the fact that oil price factors *per se* have not consistently had, and need not necessarily have, such an impact.

By late 1980 and early 1981, economic factors will once again shift against the dollar. As the U.S. pulls out of the recession relatively more quickly than the other key industrialized countries, U.S. import demand will be strengthened more quickly than demand for U.S. exports. Additionally, problems with inflation may be even more severe in an expansionary policy context, These factors, plus the overlay of oil uncertainties, make forecasts for the dollar less positive the farther out they are drawn.

The Domestic Outlook



U.S. Economy

The dramatic change in monetary policy on October 6, 1979 greatly altered the complexion of the economic outlook. Data on the third quarter showed that the economy was expanding and, thus, outperforming most expectations, while inflationary pressures remained intense, if not intensifying. Following the reported 1.4% rise in producers' prices and the 0.2 percentage point reduction in the jobless rate during September, the Federal Reserve Board acted quickly to tighten monetary policy. In an unusual Saturday move, the Fed implemented three policy changes on October 6: a 1 percentage point increase in the discount rate to 12%, the establishment of a marginal 8% reserve requirement on certain "managed liabilities," and a change in the policy focus away from specific targets for the federal funds rate to an aim of slowing the growth of the monetary aggregates.

These policy moves sent interest rates soaring, with short-term rates by the final week of October averaging between 250 and 350 basis points above their early October weekly average. The jump in short-term rates caused bond prices to fall, and the aggregate average for long-term bond yields increased approximately 50 to 100 basis points during the last three weeks of October. The commitment to slow the growth of the money supply, the added reserve requirement, and the sharp run-up in interest rates should produce a marked slowdown in economic activity, with credit-intensive areas of the economy, such as homebuilding, capital spending, and consumer durable goods spending, declining sharply in upcoming quarters.

The Third Quarter Surge

The economic results for the third quarter, however, implied that the economy has yet to enter into a recession, with the second-quarter downturn linked largely to the impact of regional gasoline shortages and strike-related production shutdowns. Real growth in the third quarter expanded 2.4%, and retail sales, employment, durable goods orders, housing, and many other statistics for September showed that the third quarter ended with an upbeat performance. A marked gain in consumer spending, notably spending on furniture, apparel, and many consumer services, helped to fuel the third-quarter expansion. Additionally, business construction activity remained robust, and the net export position improved substantially in real terms. Efforts to reduce inventories, particularly in the auto industry, were reflected in the marked lowering in real inventory investment—a trend that restrained total real economic activity last quarter.

Will the Recent Strength Fade?

The third-quarter strength in economic activity, especially in the areas of employment, housing and new orders, will support growth in the fourth quarter. The more than 10% rise in the basic money supply during the second and third quarters represents considerable monetary stimulus, which should limit a marked downturn in real growth. Real growth in the fourth quarter, however, should begin to reflect the credit-tightening stance of monetary policy. Higher finance charges should cause some postponement of capital spending projects, while increased consumer finance costs should cut into durable goods spending. After October, housing starts should decline precipitously, with the increased mortgage rates and higher monthly financing costs causing many potential homebuyers not to have the incomes to qualify for the purchase of a home.

On balance, the contrast of past monetary stimulus and current stringency may result in a decline in real growth during the fourth quarter, but that decline may be considerably less than had been expected. In the September *Economic Report* real growth was projected to decline about 4% in the fourth quarter. The recent strength in employment, housing, and new orders may limit the decline to about 1.3%. Providing support to the fourth quarter is the likely rise in business inventories, as the recent pickup in industrial production combines with a slowing in sales activity to increase inventory levels. Although housing starts should decline by year-end, the high level of building activity in the second and third quarters may limit the downward pressures on real construction spending in the fourth quarter. New orders for nondefense capital goods soared by 5.9% in September following a 4.6% gain in August. This order influx, combined with a sizable backlog of unfilled orders, should support capital spending activity in the current quarter.

Plant constuction will provide some support to 1980 economy.

The 1980 Outlook

The recent credit tightening is likely to produce a marked decline in real growth during the first quarter of next year. The sharply higher interest costs and a slowing in the growth of money supply should prompt spending declines throughout the economy. Declines in employment, initially stemming from a drop in construction and consumer products manufacturing, should produce a sharp rise in the jobless rate by early 1980. Consumer spending activity, therefore, should decline in the face of adverse employment prospects and continued downward pressures on real incomes. The falloff in sales, declines in corporate profits, and the higher cost of credit should cause many companies to defer expansion plans, and real capital spending should decline by early 1980. Efforts to minimize the cost of financing inventories should result in production cutbacks, and lower levels of inventory investment will be a depressant to real growth.

Inflation Outlook

Real output is projected to decline by 6.1% in the first quarter of 1980, and declines are likely to persist through the third quarter. Even with a recession, inflationary pressures are likely to remain quite high throughout the outlook period. Oil production cutbacks and relatively strong worldwide demand for petroleum products should contribute to higher oil prices in 1980. Relatively rapid increases in wage costs will combine with slumping productivity to produce an average rise in unit labor costs of about 10% during 1980. This increase will contribute to the upward pressures on prices, and the rate of inflation will experience an only moderate easing over the course of 1980. Higher energy prices and increased financing costs will maintain the rate of consumer price inflation near current levels well into 1980. Efforts to keep inventories at a relatively low level during the recession may mean that retailers will not resort to aggressive price discounting in order to move stocks. The GNP price deflator in 1980 should average 9.1% higher than in 1979. Consumer prices are estimated to advance 12.1%, up from 1979's 11.2% average inflation rate. On a year-end-to-year-end comparison, however, consumer prices should moderate to an 11% gain, following this year's estimated increase of 12.6%.

1980 U.S. OUTLOOK
(Billions of Dollars)

		% Change	1980 F					% Change
	1979^{E}	1978-79	I	II	III	IV	Year	1979-80
Gross National Product	2,363.5	11.1	2,455.0	2,491.0	2,545.0	2,619.0	2,527.5	6.9
Consumer Spending	1504.5	11.4	1,579.0	1,612.0	1,652.5	1,696.5	1,635.0	8.7
Durable Goods	211.0	5.4	199.5	198.0	199.0	202.5	199.7	-53.4
Autos & Parts	89.9	-1.4	77.0	75.0	75.5	78.0	76.3	-15.1
Nonauto	121.1	11.0	122.5	123.0	123.5	124.5	123.4	1.9
Nondurable Goods	593.2	11.8	627.5	639.5	657.0	675.0	649.7	9.5
Services	700.3	13.0	752.0	774.5	796.5	819.0	785.5	12.2
Gross Private Domestic Investment	389.2	10.7	376.0	365.0	365.5	382.0	372.4	-4.3
Fixed Investment	365.5	11.1	363.0	363.5	369.5	381.0	369.2	1.0
Nonresidential	252.8	14.3	263.0	267.5	273.5	280.5	271.1	7.3
Equipment	161.2	11.4	165.5	168.5	172.5	177.0	170.9	6.0
Structures	91.6	19.7	97.5	99.0	101.0	103.5	100.3	9.4
Residential	112.7	4.4	100.0	96.0	100.5	98.1	-13.0	
Inventory Investment	23.6	—	13.0	1.5	-3.0	1.0	1.0	3.1
Government Purchases	473.6	8.7	504.5	515.5	529.0	543.5	523.6	10.6
Federal	164.2	7.6	172.5	176.0	178.5	184.0	177.7	8.3
Defense	107.6	8.7	115.0	117.5	119.5	122.5	118.6	10.2
Nondefense	56.6	5.6	57.5	58.5	59.0	61.5	59.1	4.4
State & Local	309.4	9.3	332.0	341.5	350.5	359.5	345.9	11.8
Net Exports	-3.8	—	-4.5	-3.5	-3.0	-3.0	-3.5	—
GNP (1972 $)	1,427.4	2.0	1,403.8	1,394.2	1,393.8	1,402.8	1,398.6	-2.0
Real Growth Rate	2.0	—	-6.1	-2.7	-0.1	2.6	-2.0	—
GNP Price Deflator	165.6	8.9	174.9	178.7	182.6	186.7	180.7	9.1
Inflation Rate	8.9	—	9.0	8.9	9.1	9.3	9.1	—
Final Sales	2,339.8	11.1	2,442.0	2,489.5	2,548.0	2,618.0	2,524.4	7.9

E=Estimate F=Forecast

OTHER INDICATORS
(Billions of Dollars)

	1979^{E}	% Change 1978-79	1980 F I	II	III	IV	Year	% Change 1979-80
Auto Sales†	10.6	-6.2	9.0	8.8	9.0	9.3	9.0	-15.1
Housing Starts†	1.73	-13.9	1.25	1.15	1.25	1.50	1.29	-25.4
Personal Income	1,919.4	11.8	2,017.5	2,055.0	2,111.0	2,167.0	2,087.6	8.8
Disposable Income	1,621.3	11.2	1,702.0	1,735.0	1,786.5	1,833.0	1,764.1	8.8
Saving Rate (%)	4.7	—	4.8	4.5	4.4	4.9	4.7	—
Unemployment Rate (%)	5.9	—	7.2	7.9	8.1	8.0	7.8	—
Consumer Price Index*	217.4	11.2	234.5	240.8	246.7	252.5	243.6	12.1.
% Change	11.2	—	12.9	11.2	10.2	9.7	12.1	—

E = Estimate F = Forecast † = Millions of Units *1967 = 100

Growth Prospects

The 6.1% decline in real output projected for the first quarter of 1980 should be associated with a lessening in credit demands and, correspondingly, with a decline in interest rates. These financial conditions should bring about a gradual improvement in economic activity, and by the fourth quarter of next year the economy may be in a mild recovery. In addition to the reduction in interest rates, an assumed cut in personal and corporate taxes should provide support to the modest rise in economic activity late next year.

Concern over the inflationary consequences of an increased federal budget deficit may limit the size of a 1980 tax cut. Assumed in the following outlook is a $25 to $30 billion cut that will become effective during the second half of next year. About two-thirds of the assumed tax cut would accrue to individuals, probably through a cut in payroll taxes and a break for low-income taxpayers. The approximately $8 to $10 billion reduction in corporate taxes probably will be achieved by a liberalization of the depreciation allowance and/or a modest shaving of the corporate tax rates.

Consumer Spending

Sluggishness in consumer spending should persist into the third quarter of 1980, as rising unemployment rates and an already heavy debt burden dampen consumer borrowing activity. Tax relief may prompt a pickup in sales late in 1980, but the sales recovery is likely to be modest. Past losses in real incomes and the recession-reduced saving rate may cause consumers to rebuild savings, as employment increases gradually in late 1980. The midyear inflation-adjustment for social security benefits, however, should provide support for a second-half rise in the volume of spending for consumer nondurable goods and small household durable goods.

As interest rates decline in response to slowing credit demands, some of the current financial pressures on mortgage lenders may ease. Due to the strong underlying demographic demand for housing, a gradual lowering in mortgage rates should be met with an increase in home sales. Rising home sales should produce a mild recovery in housing starts during the second half of next year, but, even by year-end 1980, starts should remain considerably below the 1.83 million units average in the third quarter of this year.

OUTLOOK FOR INTEREST RATES

	1979^{E}	1980 I	II	III	IV	1980
AAA Corporate Bonds	9.56/9.62	10.00/10.25	9.50/9.75	9.25/9.50	9.25/9.50	9.50/9.75
Prime Rate	12.65/12.71	13.75/14.00	12.25/12.50	11.25/11.50	10.50/10.75	11.94/12.91

E = Estimate

A slowing in consumer borrowing will hurt TV sales.

Business Spending

The combination of sluggish sales and the high costs of financing investment projects should contribute to steady declines in the volume of capital spending into the second half of next year. The lack of excesses in current capital spending activity, however, suggests that the downturn in investment activity during the projected recession will be relatively mild, with real nonresidential fixed investment falling 3.3% from the recession's peak to trough. This slump compares with the 10.4% average decline for the prior six postwar recessions and the 18% decline in the 1973–1975 recession.

Efforts to work down inventory levels should act as a depressant to economic activity into the third quarter of next year. Although inventory management so far in 1979 has been responsive to changes in sales, the expected sharp decline in sales throughout much of the first half of 1980 may contribute to an unintended buildup of stocks. Cutbacks in production schedules to stem the rise in inventories should produce declines in employment through the second quarter of next year, resulting in a surge in the jobless rate to above 8%.

Corporate profits should decline on a quarter-over-quarter basis through the first half of next year and be lower on a year-over-year comparison throughout all of 1980. Rapidly rising wage costs and declining productivity should result in a sharp increase in unit labor costs during next year, with unit labor costs expected to average 10.2% higher. Although higher prices for nonfinancial corporate

BUSINESS TRENDS
(Billions of Dollars)

		% Change	1980 F					% Change
	1979^{E}	1978-79	I	II	III	IV	Year	1979-80
Corporate Pretax Profits	236.2	14.7	213.0	209.5	209.5	218.0	212.5	-10.0
% Change	—	—	-34.8	-6.4	N.C.	17.2	—	—
% Change Year Ago	—	—	-4.6	-8.1	-15.0	-8.0	—	—
Corporate Aftertax Profits	144.0	18.5	129.5	127.0	126.5	131.0	128.5	-10.8
% Change	—	—	-34.6	-7.5	-1.6	15.0	—	—
% Change Year Ago	—	—	-8.8	-8.8	-16.0	-9.0	—	—
Dividends	52.5	11.2	54.0	54.5	55.0	56.0	54.9	4.6
Cash Flow After Dividends	222.5	14.6	215.5	216.5	220.0	228.0	220.0	-1.1
Plant & Equipment Spending	174.4	13.4	182.0	184.5	187.0	191.0	186.1	6.7
Industrial Production*	151.9	4.7	148.5	146.3	145.0	146.0	146.5	-3.6
% Change	—	—	-8.7	-5.8	-3.5	2.8	—	—
Producer Price Index*	215.7	10.8	231.0	236.3	241.2	246.6	238.8	10.7
% Change	—	—	11.1	9.5	8.6	9.3	—	—

E=Estimate F=Forecast *1967=100

products will act to support the level of profits, the cutback in demand and increasing corporate fixed costs will put a squeeze on corporate profits margins. Aftertax earnings, therefore, are projected to decline 10% in 1980 following an 18.5% advance in 1979.

THE CALIFORNIA ECONOMY

While California's economy has slowed somewhat from the rapid economic growth of the 1977-1978 period, the state's performance during 1979 continued to outpace the nation's by a considerable margin. Currently it appears that the fourth quarter of 1979 will be a transitional period that will see a shift to a modest decline in economic activity during the first half of 1980. While state economic data are too imprecise to allow the declaration of a recession, the incipient downturn, as measured by such indicators as income and employment, is expected to be both shorter and milder in California than nationally.

Employment

Aerospace/electronics and construction have been the strongest industrial sectors of the state's economy during

1980 CALIFORNIA FORECAST

				Annual Growth Rates		
	1978^{A}	1979^{F}	1980^{F}	1977-78	1978-79	1979-80
Employment (thousands)						
Civilian Labor Force	10,632	10,928	11,273	3.8	2.8	3.2
Total Civilian Employment	9,877	10,239	10,413	6.1	3.7	1.7
Unemployment	755	689	860	-9.5	-8.7	24.8
As % of Labor Force	7.1	6.3	7.6			
Nonagricultural Wage and Salary Workers	9,230	9,702	9,774	7.4	5.1	0.7
Mining	37	39	40	2.8	5.4	2.6
Construction	416	460	462	13.5	10.6	0.4
Manufacturing	1,869	1,996	1,992	8.2	6.8	-0.2
Nondurable Goods	623	649	642	5.2	4.2	-1.1
Durable Goods	1,246	1,347	1,350	9.6	8.1	0.2
Aerospace	506	574	598	11.0	13.4	4.2
Transportation and Public Utilities	507	534	538	6.5	5.3	0.7
Trade	2,138	2,243	2,264	7.9	4.9	0.9
Finance, Insurance, and Real Estate	551	588	594	9.1	6.7	1.0
Services	1,949	2,098	2,137	10.3	7.6	1.9
Government	1,763	1,745	1,745	1.6	-1.0	N.C.
Federal	315	319	317	N.C.	.3	-0.6
State and Local	1,448	1,426	1,428	1.9	-1.5	0.1
Construction (thousands of units)						
New Housing Permits	244	206	195	-10.5	-15.6	-5.3
Single Units	142	125	121	-19.1	-12.0	-3.2
Multiple Units	102	81	74	6.7	-20.6	-8.6
Income and Spending ($ Billions)						
Personal Income	199.0	228.0	254.9	14.9	14.6	11.8
Retail Sales	86.4	99.5	107.4	12.8	15.2	8.0
Durable Goods	30.0	53.8	35.7	17.6	19.3	-0.1
Nondurable Goods	56.5	63.7	71.7	10.8	12.7	12.5
Prices (1967 = 100)						
Los Angeles Consumer Price Index	192.8	213.7	241.3	7.3	10.8	12.9

A = Actual F = Forecast

GAMES-TOYS
HOUSEWARES
Giftwares
SUNDRIES

Pre-holiday retail sales are encouraging in California.

1979. It is anticipated that total employment in the diverse industries of aerospace/electronics manufacturing will show an increase of 13.4%, or 68,000 jobs, during 1979. It should also be noted that non-aerospace durable goods manufacturing has been a weak sector thus far in 1979, showing an employment decline of over 25,000 between the first and third quarters of the year. Much of that weakness has been accounted for by transportation equipment consisting of automobiles and other motor vehicles. 1980 should see further weakness developing in the durable goods industries related to building materials, which have shown, at best, stable employment levels during 1979. Reflecting the expected slowdown in building activity that now appears to be underway, construction industry employment is expected to show a gain of 10.6% in 1979, followed by virtually no change during 1980.

The aerospace/electronics sector will once again lead the state's employment growth during 1980, although a substantially slower 4.2% growth rate is expected as production lines stabilize from the rapid buildup of 1978 and 1979. Significantly, many aerospace industry employers have reported difficulty in obtaining a sufficient number of skilled workers to staff current job openings, so that labor availability has recently been a constraint on industry growth. The weakest sector is expected to be nondurable goods manufacturing, where employment levels have been declining since early 1979. The decline is expected to continue through mid 1980, with a resumption of growth anticipated during the second half.

Total nonagricultural employment is expected to grow only 0.7% next year—the lowest rate since 1975. That increase may be contrasted with the estimated 5.1% gain of 1979 and last year's 7.4% increase. While the decline is expected to be centered primarily in the manufacturing sector excluding aerospace, virtually all sectors of the economy are expected to be considerably weaker than the trend of the 1977-1979 period. State and local government should be an exception to that pattern, since employment in the public sector is now stabilizing following the sharp decline associated with Proposition 13. The state's important trade and service sectors, broadly defined to include financial services, should hold up relatively well next year, although expected growth rates will be well below the 5%-to-10% range recorded during the 1977-1979 period.

Given the projected weakness in employment growth, it is likely that the civilian labor force will expand more rapidly than employment during 1980, producing an increase in both the number and percent of unemployed workers. The California unemployment rate is expected to increase from 1979's estimated 6.3% to an average of 7.6% in 1980. Next year's reading should thus be slightly lower than the expected national jobless rate of 7.8%, and that comparison underscores the relative strength of California's economic base.

Personal Income and Consumer Spending

The recent strong increase in employment has been accompanied by equally impressive growth in personal income, which increased almost 15% in 1978 and appears headed for another gain of above 14% in 1979, following a 7.3% rise during the first half of the year. It is important to note, however, that much of the current year's nominal income gain represents the effect of inflation, which has been somewhat higher this year in California than for the nation as a whole. Using the Los Angeles area consumer price index (CPI) as a deflator, real personal income in the state increased an impressive 7.0% in 1978. In 1979, real personal income is expected to increase only 3.4%, or about half as much as last year, reflecting the erosive effect of this year's estimated near-11% inflation rate in the state. The 1980 comparison is likely to be even worse, with inflation outrunning income gains in the state. The projected increase of 11.8% in personal income is less than the 12.9% increase forecast for the Los Angeles CPI next year, resulting in a decline of 1% in real income. Although 1980's average rate of inflation is expected to be higher, it is likely that the peak rates of increase will be attained during 1979, distorting somewhat the year-over-year comparison. By the fourth quarter of 1980, the California inflation rate is expected to be about 9% and trending downward, compared with the 18.6% annual rate realize in the second quarter of 1979.

California will not be immune from the expected national weakness in the consumer sector, and that softness will be manifested in a sharply lower 1980 growth rate of 8% for retail sales—down from an estimated 15.2% gain in 1979. Retail sales of durable goods in the state are projected to be virtually flat in 1980 in current dollar terms, resulting in a substantial decline after adjustment for inflation. The weakness in durable goods spending will be concentrated in the automotive sector. Sales of nondurable goods in the state are expected to grow at about the same rate in 1980 as during 1979—12.5%.

Home Building

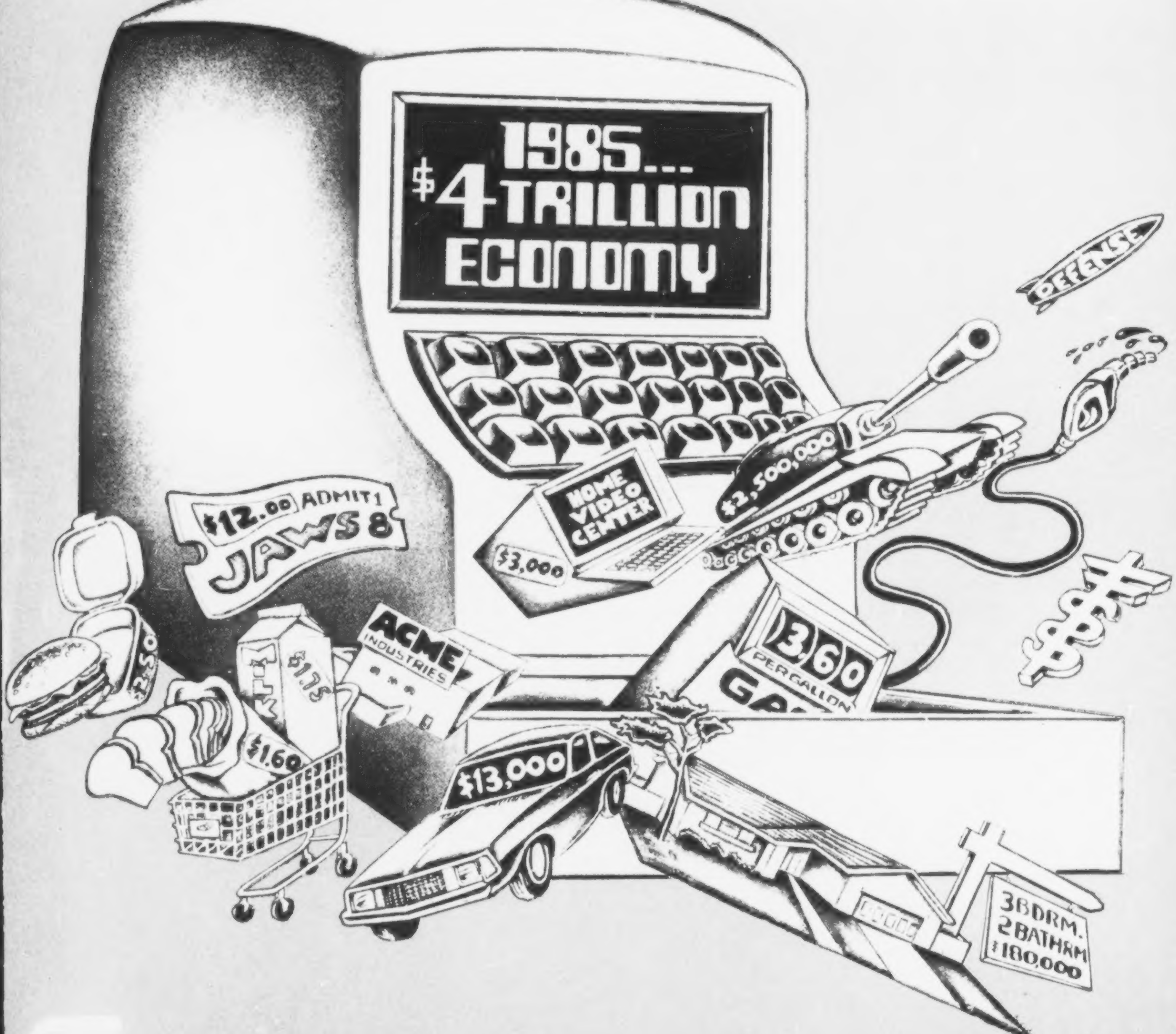
While home prices and financing costs are currently a problem for many Californians, construction activity thus far in 1979 has been relatively robust in the state. As of this writing, the effects of the Federal Reserve Board's monetary tightening during October have not yet been reflected in published California data on building activity, although the negative effect could be substantial. The fourth quarter of 1979 should show a drop of nearly 20% from third-quarter building permit levels, followed by virtually no gain during the first half of 1980, implying an annual rate of building permit issuance of about 180,000 through the second quarter of 1980. For 1980 as a whole, California residential building permits are expected to attain a total of 195,000 units, down only modestly fom 1979's estimated 206,000 units. It should also be noted that the 1980 projected total assumes a considerable salutory effect from the recent passage of Proposition 2—the usury law liberalization—at the November statewide election. It is estimated that the additional money attracted to the state by the increase in interest rate ceilings could account for an increase of as much as 10% in new housing production during 1980. Without the additional stimulus of Proposition 2, total residential building permits would have been below 180,000 for the year. Nonresidential building is expected to show a 12% increase in 1980, following strong gains in dollar volume of 26.4% and 17.5%, respectively, in 1978 and 1979.

In summary, while recent developments probably signal the beginning of a significant economic slowdown in California, a number of factors should soften the impact of the recession in the state. Continued strength in aerospace and electronics, agriculture, and foreign trade will offset weakness in other sectors such as non-aerospace manufacturing. A continued inflow of foreign tourist dollars is also expected to offset a possible reduction in travel by residents of California and other states. While recent credit-tightening measures taken by the Federal Reserve are expected to have some adverse impact on housing, it is likely that the construction industry in California, especially in the nonresidential sector, will remain stronger than for the nation as a whole.

ECONOMIC REPORT

MARCH 1980

LONG-TERM U.S. [illegible]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LONG-TERM U.S. OUTLOOK EDITION

NUMBER 59

This report highlights the long-term outlook of the United States economy through 1985. Subsequent issues of the ECONOMIC REPORT will highlight:

1981 California Outlook	**June, 1980**
National Outlook	**September, 1980**
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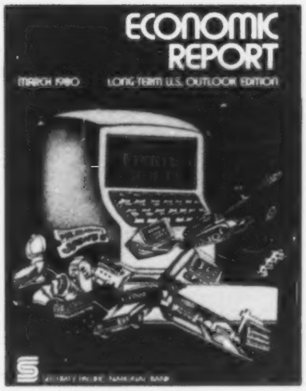
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ECONOMIC REPORT

MARCH 1980

3 **1985: The U.S. Economy—$4 Trillion**
Slower growth of potential output, deceleration of labor force growth, the productivity dilemma, and inflation limits real growth prospects over the next five years. However, some progress is expected in moderating inflation and improving productivity growth towards the end of the forecast period.

14 **Long-Term Industry Outlook—Some Improvement**
Interindustry forecast provides some insight into relative industry performance consistent with the long-term United States outlook.

18 **Demographics, Labor Force, and Employment**
An overview of demographic factors affecting the economy in the 1980's is presented along with a forecast of the labor force and industry employment.

23 **The Productivity Dilemma—A Resolution?**
The recent productivity lag is discussed and a productivity forecast by industry highlights the substantial differences among industries.

26 **Energy and Inflation**
Assumptions on the outlook for energy provide the basis for the long-term inflation forecast by economic sector and by industry.

29 **The California Economy in 1985**
A favorable climate, varied lifestyles, and a strong and diversified base will continue to attract inflows of labor and capital.

Summary

The major theme of this report is the outlook for the United States economy through 1985. By 1985, the total annual value of output of the economy will have surpassed the staggering figure of $4 trillion! Unfortunately, much of this gain is ethereal as inflation will have accounted for most of it. A detailed analysis of labor force growth and productivity concludes that potential output will grow only on the order of a 2.7 percent average annual rate through 1985, below previous estimates, but seemingly realistic in light of changing demographic factors, the recent dismal history of productivity growth, and the energy outlook. Given the difficulties that the economy is likely to encounter in achieving full employment, real output over the 1979–1985 period is projected to grow at an annual trend rate of only 2.6 percent. The trend rate of inflation, as measured by the GNP deflator, is expected to be about 8.4 percent per annum over the forecast period. The net result is an annual trend growth rate in current, or nominal, dollars on the order of 11.2 percent.

The composition of real output is expected to change in a number of respects. Both nominal and real personal consumption expenditures will be squeezed by the competing demands of the other sectors. However, real spending on durables and services should maintain at least a rate of growth in line with projected real GNP. Real investment expenditure is forecast to increase its share of output modestly as business spends more on plant and equipment. The underlying demand for housing ensures a relatively constant share of real output devoted to this key sector. The sharpest change will occur in the government sector, which is projected to decline in the aggregate. But real federal expenditures on defense are likely to increase.

The real growth and inflation forecast contained in this report is somewhat more pessimistic than most official government forecasts of the economy, but appears realistic in terms of the near-term economic difficulties the United States is facing. Although inflation remains an intractable problem, progress is expected in this difficult battle, with the average inflation rate projected to decline to the 7.5 percent area by 1985. Interest rates, both long-term and short-term, are likely to remain high, declining only modestly over the forecast horizon.

Following this broad-brush picture of trends in the economy through 1985, a summary of a detailed industry forecast is presented. Based on the use of an inter-industry forecasting model, it summarizes and ranks the real growth prospects of a number of specific industries in the context of the long-term United States outlook presented herein.

An overview of the demographic factors affecting the economy in the 1980's is then presented, along with a detailed analysis and forecast of the size and composition of the labor force for the 1979–1985 and 1985–1990 periods. Specific industry employment forecasts for the 1979–1985 period are then presented.

The debate over the productivity dilemma is summarized along with an aggregate productivity forecast. In addition, a detailed look at productivity on an industry-by-industry basis, with a forecast, is presented.

The interrelated areas of energy and inflation are treated at a more detailed level. Specific inflation forecasts for the components of GNP and the industrial composition of wholesale prices are discussed.

Finally, a forecast of California's economy by 1985 is discussed in terms of employment, personal income, and prices. Overall, California's growth prospects remain quite favorable. Although not immune to the difficulties faced by the national economy, California should generally continue to outperform the rest of the country due to its favorable climate, varied lifestyles, and a strong and diversified industry base.

1985: The United States Economy

The "aero car", the near perfect aerodynamic shape for cars in the mid-eighties could improve gas mileage up to 10 percent. Designed by J.C. Mays while a student at Art Center College of Design, Pasadena, California.

FORECAST HIGHLIGHTS: 1979–1985

Although the United States economy in 1985 is not likely to be dramatically different from today's structure, a number of important trends that can be discerned today will, nevertheless, have a very real impact looking out over five years. These underlying trends will be analyzed in some detail in this report, but no attempt will be made to forecast the detailed path of the economy from 1979 to 1985. This year's long-term forecast differs in several key respects from last year's (1978–1984). Based upon the current inflationary experience, the changing demographic forces as we look further out into the 1980's, and a reevaluation of some basic assumptions, including defense spending, the new forecast anticipates slower real growth in Gross National Product, a higher inflation rate, and a change in sectoral shares.

The basic point of departure for a long-term forecast is an attempt to project the potential output of economy through time rather than a narrow concern with short-term shifts in aggregate demand. This report discusses the role of potential output in some detail and traces the sources of economic growth in the United States in the post-World War II era. The major input in the production of aggregate economic output is, of course, labor. Important trends in the labor force are underway with implications for the economy over the next five years quite different from the past five years' history. Since 1973 a major dilemma of the American economy has been the lag in labor's productivity growth. An attempt is made to explain this recent lag and to make some cautious assessments about its possible future path.

Once the underlying trend in potential output has been analyzed and forecast, the crucial step is to relate aggregate demand to potential. The critical issue in assessing the extent of any "gap" between actual and potential output is a determination of the rate of unemployment at which the labor force is considered fully employed. Having forecast the levels of both potential and actual output in the economy by 1985, the composition of this output is then analyzed in terms of the four major expenditure categories: personal consumption, gross private domestic investment, government purchases, and net exports.

No other single issue has occupied economists and policymakers in recent years as has inflation. An attempt is made to forecast the trend of inflation through 1985 and to differentiate inflation's impact upon the several sectors of the economy. The ability of the corporation to adjust to the underlying growth trend of the economy and to deal with the problem of inflation is a key determinant of aggregate corporate profits. These, along with the other major factors determining corporate profits, will be discussed as well as the outlook for dividend policy. The rate of inflation is also a key determinant in forecasting the average level of interest rates over this period.

Some of the risks to the forecast are briefly sketched to point out possibilities that, on the one hand, are a bit more optimistic and, on the other hand, more pessimistic in terms of the serious inflationary problems that the economy faces over this period. This is discussed in the context of the constraints facing policymakers in the areas of fiscal, monetary, and "incomes" policies.

Forecast Summary
1979-1985

- Slow, gradual unwinding of inflation with relatively sluggish real growth of the economy
- Cyclical recovery in the early 1980's following a downturn
- Gradual decline in the inflation rate to the 7.5% area by 1985
- Relatively restrictive monetary policy and a gradual reduction in the federal budget deficit
- Above-trend real growth of the investment sector
- Above-trend real growth of federal defense expeditures
- Interest rates to remain high, declining only modestly over the forecast horizon
- Corporate profits growth in line with the economy

FORECAST SUMMARY
1979–1985
(in billions)

Aggregate Demand	**1973**	**1979P**	**1985F**
Potential GNP (1972 $)	1219.9	1466.0	1720.0
Real GNP (1972 $)	1235.0	1431.1	1669.0
GNP Gap (%)	-1.2%	2.4%	3.0%
Unemployment Rate	4.9%	5.8%	7.0-7.5%
Nominal GNP (current $)	1306.6	2368.5	4481.0
Growth Trends	**1973-79**	**1979-85**	
Real GNP	2.5%	2.6%	
Inflation	7.7	8.4	
Nominal GNP	10.4	11.2	

Finally, a brief epilogue on the 1985-1990 period indicates some further shifts in the economy that appear likely to occur by the end of the decade. The accompanying table briefly summarizes the highlights of the forecast from 1979 to 1985 and its quantitative dimensions are presented in the forecast summary.

THE ROLE OF POTENTIAL OUTPUT

The potential output path of the economy has generally tended to be a fairly smooth trend line, given the relatively stable trend growth of both the labor force and its productivity. It is also the trend path of full-employment output and gives the level of output that could be obtained with the unemployment rate at its so-called full-employment rate and labor productivity growth at its historical trend value. When actual GNP is below potential output, unemployment is above the full-employment unemployment rate (F.E.U.R.) and real output is lost. This difference between potential and actual real output is referred to as the GNP "gap." Conversely, when actual output is above potential, some additional output is temporarily gained, but only at the cost of a higher rate of price inflation. Thus, the potential output path does not represent an absolute physical maximum, but rather gives the level of output associated with a "full-employment" rate of unemployment and one that would be compatible with reasonable price stability.

A Moving Target

Evidence in recent years suggests that previous official estimates of the trend growth rate of potential output have been overly optimistic. Given a post-war productivity trend on the order of 2 percent annually combined with rapid expansion of the labor force, most official calculations had potential output growing at a trend rate of at least 3.5 percent. However, since 1973, productivity growth in the economy has faltered, while the labor force has made unprecedented gains. Meanwhile, the economy has experienced severe inflationary pressures, and the ability to reach the hypothetical potential without aggravating inflationary pressures has been seriously questioned by most analysts inside and outside the government. Apparently heeding the call to reassess those potential output calculations, the Council of Economic Advisors in the *1979 Economic Report of the President* reevaluated the official estimates and revised them downward significantly. The revised estimates, from 1973 to 1978, imply that the trend growth of potential output over this period was only 3.0 percent, as follows: labor force growth, 2.5 percent; manhours per worker, -0.5 percent; and productivity, 1.0 percent. Furthermore, its projection of potential output from 1978 to 1983 was similarly 3.0 percent. However, the composition had a lower labor force growth and some anticipated rebound in productivity.

In the *1980 Economic Report of the President*, the Council has hedged its bets. It has "temporarily" lowered its potential output estimate from 3 to 2.5 percent during the three years beginning with the first quarter of 1979. This drop is attributed to the dismal near-term productivity outlook. Then the Council expects productivity to rebound to the 1.5 to 2.0 percent range, yielding a growth in potential output over the 1982–1985 period that is near 3 percent.

Estimating the Potential Path

However, recent work done by Security Pacific Bank, Data Resources, Inc., and others casts serious doubt on the CEA appraisal, viz., a "rebounding trend" back to the 3 percent per annum area for potential output. Security Pacific Bank now estimates potential GNP growth from 1979 to 1985 to average only 2.7 percent per year. Over this six-year period, growth in the labor force is expected to average 1.8 percent per year. Declines in manhours per worker should be on the order of 0.5 percent, giving a net labor input of 1.3 percent. Despite the recent dismal performance in productivity and a near-term expectation of very little improvement, it is anticipated that a rebound will occur in the early 1980's that will bring the average for the period to 1.4 percent.

CALCULATION OF POTENTIAL GNP GROWTH
Annual Trend Growth Rates

	SPNB Forecast 1979–85
Labor Force	1.8%
Manhours per Worker	-0.5
Productivity	1.4
	2.7%

SOURCES OF ECONOMIC GROWTH
IN THE UNITED STATES
1950–1979
(Annual Trend Growth Rates)

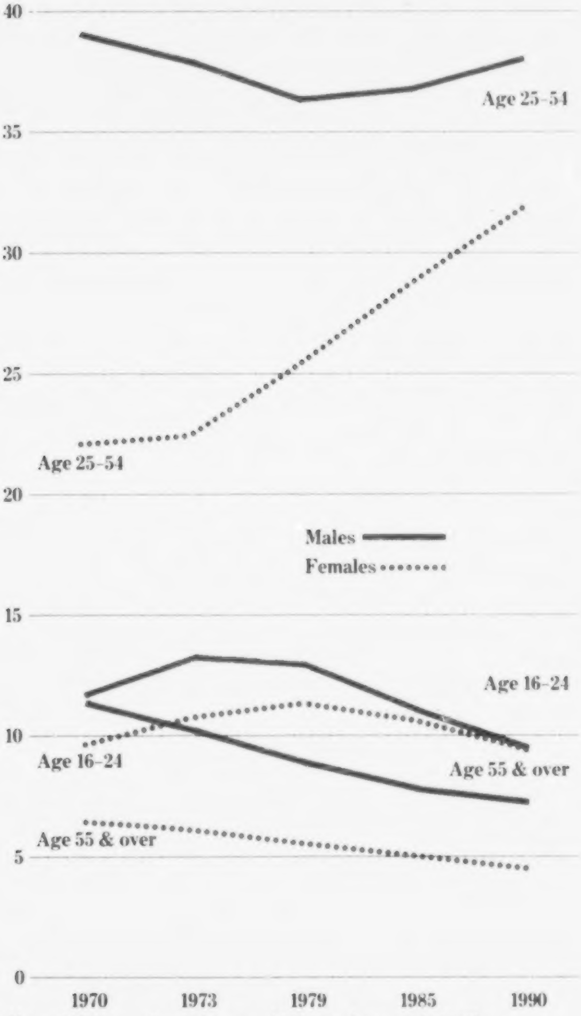
Periods	Civilian Labor Force	Average Weekly Hours†	Productivity‡	Actual GNP	Potential GNP§
1950-79	1.8%	-0.4%	1.9%	3.5%	3.3%
1950-73	1.6	-0.3	2.3	3.7	3.3
1950-55	0.9	-0.1	2.1	4.2	2.3
1955-65	1.4	-0.2	2.6	3.5	3.5
1955-73	1.7	-0.4	2.3	3.6	3.6
1955-79	1.9	-0.4	1.9	3.3	3.5
1965-73	2.2	-0.6	2.0	3.7	3.8
1965-79	2.3	-0.6	1.3	3.2	3.5
1973-79	2.5	-0.5	0.5	2.5	3.1

†Total private nonagricultural
‡Output per hour, nonfarm business sector.
§Based on DRI est.

SOURCES OF ECONOMIC GROWTH

In order to put today's difficulties and the longer-term forecast into proper perspective, it may be useful to review briefly the history of growth in the United States economy in the post-World War II era. From 1950 to 1979, the annual trend rate of growth in the economy has been about 3.5 percent in real terms. Over this long stretch, the labor force has grown at 1.8 percent, average weekly hours have declined 0.4 percent, and productivity has grown 1.9 percent. However, a closer look at the sub-periods summarized in the accompanying table illustrates that the pattern of growth has varied considerably. The rapid spurt in output from 1950 to 1965 was paced by rapid gains in productivity. In the Vietnam War era from 1965 to 1973, the trend rate of growth was a very strong 3.7 percent. Productivity gains remained fairly high at 2.0 percent, but the civilian labor force expanded at 2.2 percent rate. Tempering this rapid expansion of the labor force, however, was an accelerating decline in average weekly hours. Nevertheless, this was a period of historically high growth of both potential and actual output. Since 1973, however, the trend in potential output dropped to only 3.1 percent. The major contribution to growth in this most recent era was the unprecedented expansion in the labor force as the "baby boom" children of the 1950's reached working age and the number of women entering the labor force accelerated rapidly. The labor force will again be the most significant factor contributing to potential output growth through the mid 1980's, but at a considerably slower rate than in the recent past. A more detailed assessment of these basic sources of growth is presented in the following sections.

PERCENTAGE SHARE OF CIVILIAN LABOR FORCE



Note: All figures for each year added together equals 100%
Source: Based on BLS data and SPNB projections

THE CHANGING LABOR FORCE

No single factor in the determination of economic growth is more critical or as pervasive as the labor force. Labor is the primary input in the production of aggregate output and the income derived by labor is the major source of expenditures in the economy. Aggregate numbers on the civilian labor force only begin to tell the story. Even though with a known population base it would seem a very straightforward calculation, analysts have continually underestimated its growth. From 1950 to 1979, the total civilian labor force grew 1.8 percent per annum. Since 1973, however, it has grown at about a 2.5 percent rate, but a significant slowdown in the growth of the labor force is expected in the 1980's.

Determinants of the Labor Force

In any given period of time, a certain percentage of the total population is actively seeking employment in the monetized sector of the economy. This group constitutes the active labor force. The percentage of this group unable to find suitable employment is referred to as the unemployment rate. Thus, it is self-evident that the size of the population is a major determinant of the civilian labor force. From 1970 to 1979 the total population grew at a 1.8 percent annual trend rate. However, population trends in the 1980's are likely to be considerably different. From 1979 to 1985, total population will grow at only a 1.1 percent trend rate. From 1985 to 1990, civilian noninstitutional population growth will decelerate further to 0.8 percent.

One of the most troublesome variables to forecast in recent years has been the labor force participation rate. Most public as well as private forecasters estimate an increase in the participation rates among most population groups, but especially among women. The data presented in this report, although partly based on a revised set of projections from the Bureau of Labor Statistics, were revised upward in the light of more recent evidence. The overall civilian labor force participation rate is projected to rise from 63.7 percent in 1979 to 66.3 by 1985. The rate for all men is expected to remain flat over the period at 77.9 percent, and the rate for all women is expected to continue rising, from 51.0 percent in 1979 to 55.9 percent by 1985.

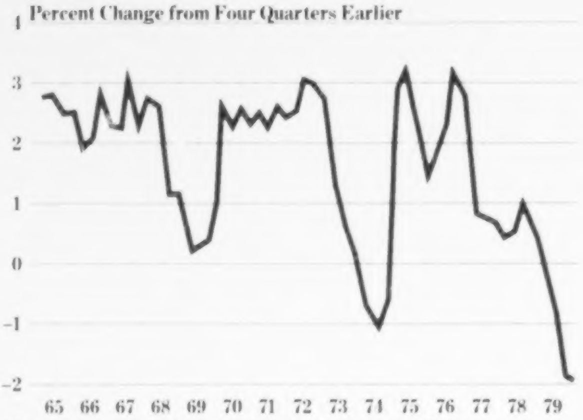
The accompanying graph illustrates the changing composition of the labor force over time. Men in the central age group, age 25 to 54, will experience a decline in its relative share of the labor force from 1970 to 1990, but will actually experience a slight recovery from 1979 to 1985. On the other hand, women in the central age group, age 25 to 54, will continue to expand its relative share, from 22.0 percent in 1970 to 31.8 percent by 1990.

The maturing of the labor force should lead to a more productive labor force. The greater productivity of a more experienced workforce should partially offset the slower labor force growth in the 1980's. The impact of more women in the labor force is ambiguous and will depend on the extent to which women with children will be able to work full time.

A separate section of this report is devoted to a more detailed analysis of the labor force.

The Declining Workweek

Another factor in the post-World War II period has been the declining trend in average weekly hours worked. In the total private nonagricultural sector, the workweek had declined from 39.8 hours in 1950 to an estimated 35.7 hours in 1979. The trend over this period has been an average annual decline of 0.4 percent. However, the long-term trend rate conceals some acceleration of the declining workweek. From 1950 to 1965 the annual de-



RECENT PRODUCTIVITY GROWTH

(Adjusted for Cyclical Variation)

Note: Data are for private nonfarm business sector all persons
Source: Council of Economic Advisors

MCA's "Discovision" videodisc systems (left) offer pre-recorded visual entertainment in the home. Right, discs used in RCA's "SelectaVision" VideoDisc system.

cline was only on the order of 0.2 percent. If measured from 1955 to the present, the decline was only on the order of 0.4 percent, but in more recent years, viz., since 1965, the decline has been on the order of 0.6 percent.

A number of factors have contributed to this trend of declining hours worked including: productivity growth, preference for leisure over work, the continuing shift from agriculture and industry into services, the increase of women and teenagers in the labor force, and the growing acceptance by many employers of more flexible scheduling and the use of part-time employees. Some easing of the trend of recent years is expected looking out to 1985, with the decline expected to average only 0.5 percent annually over the forecast period.

THE PRODUCTIVITY DILEMMA

As discussed above, productivity growth has been a key source of overall economic growth in the United States, both in the period following World War II and over an even longer historical horizon. However, the recent history of productivity has been quite dismal, and no immediate improvement is in sight. This lagging productivity is one of the root causes of our current inflationary problems and our balance-of-payments difficulties.

UNEMPLOYMENT BY AGE/SEX COMPOSITION

	Historical Unemployment Rates			
	1965	1973	1978	1979
Male				
16–19	14.1%	13.9%	15.7%	15.8%
20–24	6.3	7.3	9.1	8.6
25–34	3.0	3.3	4.3	4.2
35–44	2.6	2.0	2.8	2.9
45–54	2.5	2.1	2.8	2.7
55–64	3.3	2.4	2.7	2.7
65+	3.5	3.0	4.2	3.5
Men – 16 & over	4.0	4.1	5.2	5.1
Female				
16–19	15.7	15.2	17.0	16.4
20–24	7.3	8.4	10.1	9.6
25–34	5.5	5.8	6.7	6.4
35–44	4.6	3.9	5.0	4.6
45–54	3.2	3.2	4.0	3.9
55–64	2.8	2.8	3.2	3.2
65+	2.8	2.9	3.8	3.3
Women – 16 & over	5.5	6.0	7.2	6.8
Total	4.5%	4.9%	6.0%	5.8%
GNP Gap ($B)	-23.2	-15.1	25.3	34.9

UNEMPLOYMENT BY INDUSTRY

	Unemployment Rates	
	1973	1979
Agriculture	6.9%	9.1%
Nonagriculture	4.5	5.4
Mining	2.9	4.9
Construction	8.8	10.2
Manufacturing	4.3	5.5
Durable goods	3.9	5.0
Nondurable goods	4.9	6.4
Transportation, communication and public utilities	3.0	3.7
Wholesale and retail trade	5.6	6.5
Finance, insurance and real estate	2.7	3.0
Other services	4.8	5.4
Government	2.7	3.7
Total Civilian Unemployment Rate	4.9%	5.8%

Source: BLS

Why Productivity Has Lagged

Since 1973 productivity in the nonfarm business sector has averaged only 0.5 percent compared with a post-war trend of near 2.0 percent. A number of factors, some measurable but others more subtle, have accounted for this disappointing performance. The economic "boom-bust" cycle of the early 1970's, exacerbated by the Arab oil embargo of 1973, has discouraged capital investment in plant and equipment. The capital stock in relation to the labor force, i.e., the capital-labor ratio, has declined and is not expected to achieve its pre-1973 level in the foreseeable future. Another difficulty stems from the legislated environmental tradeoffs, which caused much of the actual capital investment to be put into such "nonproductive" investment as pollution abatement and control equipment. The abrupt turnaround in the relative price of competing energy sources also required a significant investment just to accommodate this change.

Perhaps less obvious, but of a fundamental nature, has been the lag in research and development expenditure by private businesses and the federal government. During the 1960's, basic research was strongly supported by the government. However, in the late 1960's, Administration policies backed away from support of basic research, and, with the slowdown in the space program, private industry lost this favorable fallout.

The changing structure of the economy is also a major factor in the decline in productivity growth. The greatest productivity advances in output per manhour generally occur in high technology, manufacturing industries and traditionally, of course, American agriculture has been a major contributor to overall productivity growth. But the trend of recent decades toward a larger service sector economy makes it difficult to achieve the same rate of productivity advances of an economy in an earlier stage of industrial evolution. Advances in productivity in the highly labor-intensive service sector are difficult to achieve. A more detailed appraisal of the productivity problem, including specific industry data, is presented in a subsequent section of this report.

Guarded Optimism

There are no immediate signs of relief from the productivity slowdown the economy is currently experiencing. Certainly the near-term cyclical outlook is not encouraging. However, with a cyclical rebound, a slowdown in the rate of growth in the labor force, and some improvement in the investment area, the trend growth in productivity through 1985 should show a considerable improvement over the recent past. There has been some pickup in both governmental and private business expenditures on research and development. This resurgence is critical if a sustained longer-term growth in productivity is to be achieved. Investment in producers' durable equipment by the private sector should help to improve the capital-labor and capital/output ratios by 1985. And, finally, the maturing of the workforce should contribute to productivity improvement.

UNEMPLOYMENT AND THE GAP

The relationship between the unemployment rate to the "gap" between actual and potential output, referred to as Okun's Law, has been a troublesome issue in the recent past as a method of forecasting the unemployment rate. But despite the instability of Okun's Law in today's inflationary environment, it appears unlikely that full employment can be achieved by 1985. The GNP gap may decline slightly from the 2.4 percent in 1979 by 1983 or 1984, but appears headed higher again by 1985 to around

LONG-TERM U.S. ECONOMIC OUTLOOK
1979–1985
(billions)

	(Current $)		(1972 $)	
	1979P	1985F	1979P	1985F
Gross National Product	2368.5	4481	1431.1	1669
Personal Consumption Expenditures	1509.8	2817	924.5	1069
Durable Goods	212.8	372	147.0	174
Autos and Parts	91.3	169	58.5	69
Except Autos and Parts	121.6	203	88.5	105
Nondurable Goods	597.0	1095	349.3	395
Services	700.0	1350	428.2	500
Gross Private Domestic Investment	386.2	762	214.8	254
Fixed Investment	367.8	732	204.6	244
Nonresidential	253.9	494	148.2	178
Producers' Durable Equipment	161.6	308	100.3	122
Structures	92.3	186	47.9	56
Residential	113.9	238	56.5	66
Change in Business Inventories	18.4	30	10.2	10
Government Purchases	476.1	912	274.1	316
Federal	166.3	333	99.2	121
Defense	108.3	226	64.7†	82
Nondefense	58.0	107	34.4†	39
State and Local	309.8	579	174.9	195
Net Exports	-3.5	-10	17.7	30

P = Preliminary F = SPNB Forecast † = Estimate

3.0 percent. The unemployment rate is likely to rise from the 5.8 percent average level in 1979 to the 7.0 to 7.5 percent range by 1985.

Full-Employment Unemployment Rate

There are many conceptual difficulties in trying to calculate a nominal unemployment rate that is, in effect, consistent with a fully-employed economy. In today's inflationary environment, most traditional estimates of the F.E.U.R. are deemed too low. The unemployment rate traditionally has been viewed as a measure of "slack" in the labor force. However, more recent concepts emphasize an F.E.U.R. that incorporates the concept of a "nonaccelerating inflation" rate of unemployment. This rate is clearly higher than most traditional estimates, but conceptually and empirically it is very difficult to use in making longer-term forecasts.

A simple method of calculation uses historical full-employment unemployment rates of the different sex-age categories and applies them to the forecasted labor force in 1985. This approach leads to an F.E.U.R. of 4.8-4.9 percent if 1965 and 1973 are considered the relevant full employment benchmarks. However, if the last two years are considered a more realistic benchmark, then an appropriate F.E.U.R. by 1985 is 5.7-5.9 percent.

Using unemployment rates by industrial employment categories and applying them to projected employment by industry in 1985 sheds little further light on the issue. The projected F.E.U.R. is 4.5 percent using 1973 rates, but climbs to 5.4 percent using the presumably more realistic 1979 unemployment rates.

Thus, an estimate for the full-employment rate of unemployment by 1985 is in the 5 to 6 percent area, with 5.5 percent a reasonable point estimate.

REAL OUTPUT AND INFLATION

Over the 1979-1985 period, the annual trend growth of the economy is forecast to be on the order of 11.2 percent. However, only 2.6 percent is accounted for by real growth and 8.4 percent is the result of inflation. From 1973 to 1979, nominal output grew at 10.4 percent annual rate, real GNP by 2.5 percent, and inflation at 7.7

GNP GROWTH & SECTORAL SHARES

	1979-85 Growth Trend		Share of GNP (Current $)		Share of GNP (1972 $)	
	(Current $)	(1972 $)	1979	1985	1979	1985
Gross National Product	11.2%	2.6 %	100.0%	100.0 %	100.0%	100.0%
Personal Consumption Expenditures	11.0	2.4	63.7	62.8	64.6	64.1
Durable Goods	9.8	2.9	9.0	8.3	10.3	10.4
Autos and Parts	10.8	2.8	3.9	3.8	4.1	4.1
Except Autos and Parts	8.9	2.9	5.1	4.5	6.2	6.3
Nondurable Goods	10.6	2.1	25.2	24.4	24.4	23.7
Services	11.6	2.6	29.6	30.1	29.9	30.0
Gross Private Domestic Investment	12.0	2.8	16.3	17.0	15.0	15.2
Fixed Investment	12.2	3.0	15.5	16.3	14.3	14.6
Nonresidential	11.7	3.1	10.7	11.0	10.4	10.7
Producers' Durable Equipment	11.3	3.3	6.8	6.9	7.1	7.3
Structures	12.4	2.6	3.9	4.1	3.3	3.4
Residential	13.1	2.6	4.8	5.3	3.9	4.0
Change in Business Inventories	8.5	–	0.8	0.7	0.7	0.6
Government Purchases	11.4	2.4	20.1	20.4	19.2	18.9
Federal	12.3	3.4	7.0	7.4	6.9	7.3
Defense	13.0	4.0	4.6	5.0	4.5	4.9
Nondefense	10.7	2.1	2.4	2.4	2.4	2.3
State and Local	11.0	1.8	13.1	12.9	12.2	11.7
Net Exports	–	9.2	-0.1	-0.2	1.2	1.8

percent. These numbers highlight the difficulties of achieving noninflationary growth in the foreseeable future. The accompanying tables provide a detailed forecast of the expenditure components of Gross National Product in nominal and real terms. GNP growth and sectoral shares, nominal and real, are also presented.

Personal Consumption: A Squeeze

Total personal consumption expenditures are expected to decline from 63.7 percent of nominal GNP in 1979 to 62.8 percent in 1985. In real terms, the share drops from 64.6 percent to 64.1 percent. The real growth in durable goods will be above trend for autos, household furnishings, and appliances. The growth of nondurables should be below trend as both food and fuel consumption decline as a result of inflationary pressures. The service sector is expected to continue its trend growth through 1985, with greater relative growth in such areas as health care and leisure and lesser growth in education.

Private Investment: Up a Little

Private investment is expected to grow somewhat above the GNP trend in real terms, but a full-fledged capital spending boom is not foreseen. A certain amount of catch-up is implicit in the real growth of producers' durable equipment as business seeks to increase productivity. Residential fixed investment, on trend in real terms, remains relatively strong despite cyclical problems. However, inflation accounts for much of the nominal increase. Tighter management control of inventories should maintain inventory investment at a fairly even keel over this period.

Government Purchases: Defense Rebounds

The real share of government purchases is expected to decline from 19.2 percent in 1979 to 18.9 percent by 1985. The decline in state and local spending, while reflecting some post-Proposition 13 influences, is primarily the result of demographic factors. Enrollment declines at the elementary and high school levels will mean much slower real growth in educational expenditures.

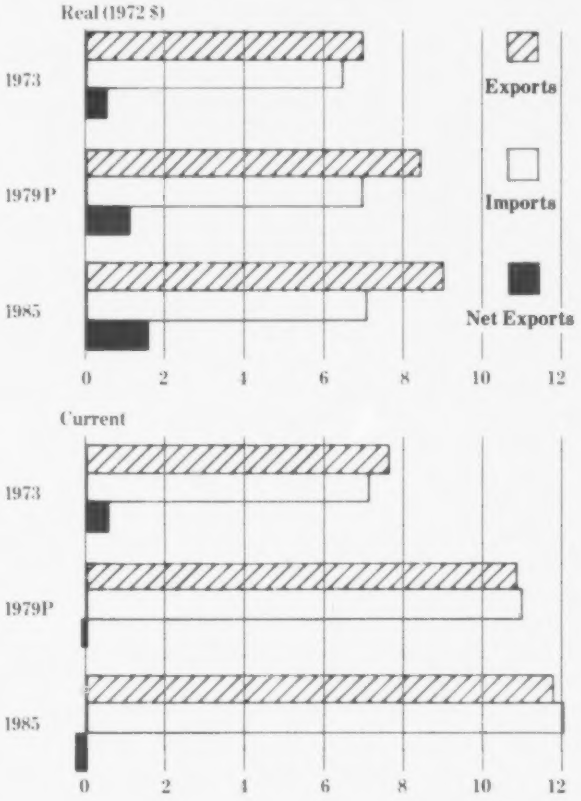
A major change in the forecast is at the federal level. Recent world developments have heightened the realization that real defense spending must increase sharply in the coming years to maintain a credible national defense posture. A real growth rate of 4 percent through 1985 will not be easy to achieve in the face of high inflation and the competition for scarce resources. However, even this above-trend growth of real defense expenditures will not bring its share of real output back to where it was in 1973. That sort of commitment would require real growth in excess of 6 percent annually.

The Foreign Sector

Net exports are expected to improve, in real terms, from $17.7 billion in 1979 to approximately $30 billion by 1985. Real export growth is expected to be on the order of 3.8 percent annually with real imports growing at a 2.7 percent rate. However, because of continuing price pressures from petroleum imports, the rate of inflation in the import sector will continue to exceed that of exports (10.0 percent versus 8.8 percent). The overall effect would be to increase the net export deficit in nominal dollars from $3.5 billion in 1979 to about $10 billion by 1985.

The accompanying graph illustrates the inexorable growth of the foreign sector's impact on the United States economy. Import prices are having a severe impact on domestic inflation and more real output must be devoted to exports to pay for higher priced imports.

FOREIGN SECTOR OUTLOOK
(Percent Share of GNP)



INFLATION FORECAST
1979–1985
(Annual Trend Rates)

	1973–79	1979–85F
Personal Consumption Expenditures	7.6%	8.3%
Gross Private Domestic Investment	9.2	8.9
Government Purchases	8.5	8.8
Exports	10.8	8.8
Imports	13.7	10.0
Implicit Price Deflator (GNP)	7.7%	8.4%

Inflation

Inflation remains the major economic issue and the most difficult problem for policymakers and analysts to deal with. Energy is the key to the inflationary crisis both by its direct as well as indirect impacts. Near-term, there appears to be little hope for a slowdown in price pressures. However, the overall inflation forecast (GNP deflator) of 8.4 percent annual trend rate through 1985 assumes an easing of the inflation rate to the 7.5 percent area by the end of the forecast period. The accompanying table summarizes the expected inflation rates by major economic sectors. A separate section of this report provides a more detailed appraisal of the energy and inflation issues.

CORPORATE PROFITS OUTLOOK
1979–1985

	(Current $— billions) 1979P	(Current $— billions) 1985F	Growth Trend 1973–79	Growth Trend 1979–85F
Corporate profits w/IVA & CCA	178.4	291.0	10.3%	8.5%
Corporate profits before taxes	237.0	404.0	12.7	9.3
Corporate profits after taxes	144.7	250.0	13.7	9.5
Capital consumption allowance	131.0	270.0	10.0	12.8
Total CPAT & CCA	275.7	520.0	11.8	11.2
Dividends	52.8	97.5	11.3	10.8
Cash flow minus dividends	222.9	422.5	12.0	11.2
Retained Earnings	92.0	152.5	15.2	8.8
Capital consumption adjustment	–16.7	–58.0		
Inventory valuation adjustment	–41.9	–55.0		
Effective Tax Rate	38.9%	38.1%		
Dividend Payout Ratio	36.5%	39.0%		

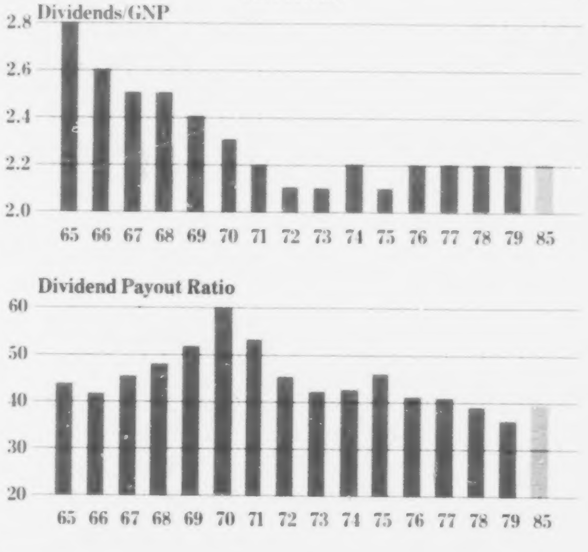
CORPORATE PROFITS

With a sluggish real growth rate of 2.6 percent and an inflation rate of 8.4 percent, corporations will be somewhat hard-pressed to maintain growth rates in profits, especially at the pretax level. However, compared to the difficulties in dealing with the unanticipated inflation in the early 1970's, it is assumed that corporations have learned to deal much more effectively in protecting their margins in today's inflationary environment. Capacity utilization rates in manufacturing are expected to improve gradually. Interest rates are expected to remain relatively high, both long-term and short-term, exerting further pressures on profits. But a key difficulty lies in the expected increase in unit labor costs, which are forecast to grow at an annual rate of 8.2 percent over the period.

Although pretax profits are expected to grow only at 9.3 percent, after-tax profits should grow at about 9.5 percent as a result of an expected lower effective corporate tax rate.

After-tax profits of nonfinancial corporations, however, should grow somewhat above trend, with relatively less favorable growth in the financial corporate sector. No significant change from recent trends is expected in dividend policies. The chances of achieving a higher dividend payout ratio appear slim in light of the fact that corporations will need to retain at least the same proportion of after-tax earnings if they are to

TRENDS IN DIVIDENDS 1965–1985F
(In Percent)



Above, the Navy's newest strike fighter from McDonnell Douglas, the F-18; Right, the XM-1, the Army's first turbine powered tank, developed by Chrysler.

achieve expected investment levels. The high profit levels apparently achieved in 1979 and the concomitant drop in the dividend payout ratio is a cyclical phenomenon that makes the resulting earnings forecast from this base look a bit less favorable than it actually is.

INTEREST RATES

Forecasting the long-term trend in interest rates is hazardous at best. Needless to say, interest rates can be expected to be quite volatile over any period this long. The nominal long-term rate, as represented by the corporate bond rate, comprises the real rate of interest and the inflation rate. The real rate of return on capital has tended historically to be in the 2-2½ percent range, although since 1973 it seems to have dropped down to just over 1 percent. The primary reason for this recent discrepancy appears to be the miscalculation by long-term investors of the expected inflation outlook. Given our inflation assumption of about 8.4 percent and the expectation that the historical required real rate of return will begin to re-assert itself, average long-term rates should be on the order of 10⅝ percent as represented by the AAA corporate bond rate. However, we expect moderation of the inflation rate in the 1980's and a concomitant lowering of the bond rate.

Short-term rates are dependent on both monetary policy of the Federal Reserve as well as cyclical conditions in the economy. But, on average, we do not expect short-term rates to drop to previous historical norms in light of the higher built-in inflation in today's economy. The accompanying table presents the forecast of representative short-term and longer-term interest rates as average rates over the six-year forecast period.

INTEREST RATE OUTLOOK
1979-1985

	5-Year Average 1975-79	1979	SPNB Forecast 1980-85 Average
Short-Term			
Commercial Paper – 90 day – dealer	7.26	11.05	10½
Prime Rate	8.66	12.72	12⅛
Treasury Bills – 3 month	6.66	10.10	9¾
Treasury Bills – 12 month	7.57	10.78	10¼
Federal Funds	7.11	11.23	10⅝
Certificates of Deposit – 3 month	7.39	11.35	10¾
Longer-Term			
3-5 Year U.S. Governments	7.88	9.67	9⅞
New AAA Corporate Bonds	8.83	9.89	10⅝
New AA Utilities	9.16	10.26	11

POLICY CONSTRAINTS

Although the above forecast is viewed as realistic and most probable, many events can impinge upon the economy to cause this forecast to miss the mark. On the one hand, it is possible that near-term inflationary pressures are overestimated and thus the trend rate of inflation is overestimated. If so, somewhat more rapid real growth could be expected, and the economy would reach full employment by 1985. However, if the inflationary pressures are still being significantly underestimated, the risks to real growth are substantial. And if inflation continues to accelerate indefinitely into the future, at present still a low probability event, then the structure and ground rules of the economic system will have to undergo major changes.

Inflation and pressures from defense spending will make it difficult at best for the federal government to achieve a balanced budget by 1985. There is virtually no leeway for expanding non-defense federal expenditures at an above-trend rate. For much of the forecast period monetary policy will have to remain relatively restrictive, both to combat domestic inflation and to prevent any further deterioration in the international position of the dollar. Failure of fiscal and monetary policies to slow down inflation will lead to a much stronger "incomes" policy approach than the current voluntary wage-price guidelines, with comprehensive controls the final resort.

EPILOGUE: 1985-1990

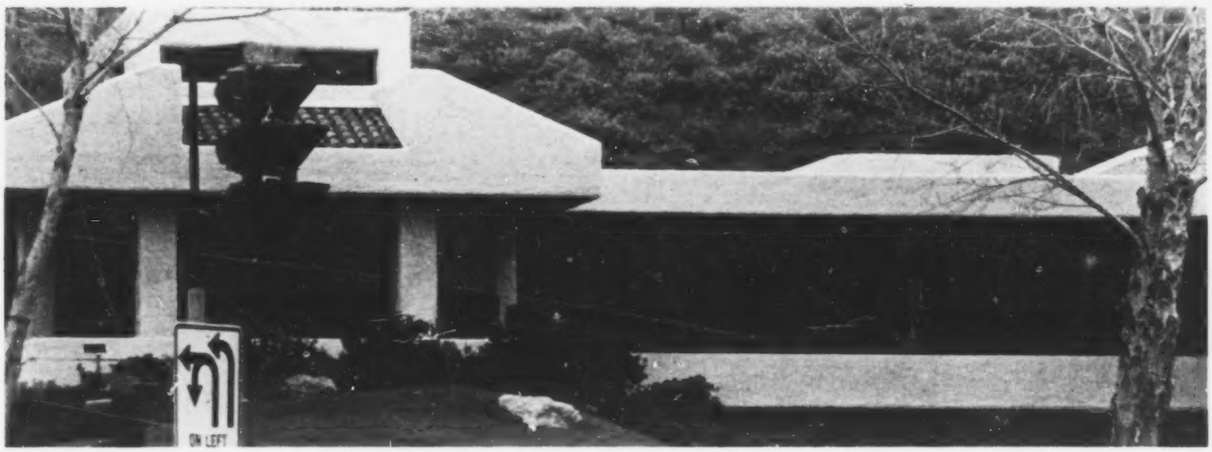
Is there a happy ending to the austere scenario painted in this report? In many ways, things should be better in the second half of the decade. The economy will have made substantial progress in adjusting to high energy costs. The United States will be less dependent on foreign sources of energy, but this achievement will be extremely costly.

The growth of the labor force will decelerate further and productivity should improve. However, the potential output trend is still not likely to be any higher than the 2.7 percent annual trend rate forecast through 1985. Investment in residential construction should finally slow down after its long cyclical upswing and real personal consumption should make something of a comeback.

JEAN-PIERRE
RAMPAL

Above left, skier—San Bernardino Mountains; Above right, skaters at Venice Beach;
Middle, Dorothy Chandler Pavilion—The Music Center; Bottom, Top-of-five restaurant—L.A. Bonaventure.

Long-Term Industry Outlook



Industrial parks of the 80's will resemble this type of development.

SOME GENERAL CONCLUSIONS

The long-term forecast is reasonably optimistic on the outlook for the capital goods sector. Above-average growth can be expected in areas such as energy conservation, high technology, and automation. Recent tax reform should encourage business investment somewhat, but cost of capital considerations will tend to dampen any real capital spending boom.

Implications for the housing sector are also favorable with starts in the 1.5 to 2.2 million unit range during the 1979–1985 period and averaging a relatively high 1.9 to 2.0. After a near-term cyclical downturn, trend growth in housing should be more in line with GNP growth and multiple-unit dwellings should recover more rapidly in the post-1980 period.

The automobile outlook is less favorable. Real growth will be slightly above GNP trend. However, cyclical considerations, energy legislation, environmental pressures, rising labor costs, and foreign competition are all working to inhibit any increase in the domestic industry's share of personal consumption expenditures in current dollars. Replacement demand and considerations of fuel efficiency should help maintain auto sales in a range of 10.0 to 12.0 million units annually over the forecast period.

The expected increase in real defense expenditures will clearly bolster areas of the aerospace and electronics industries, but to some extent at the expense of real personal consumption.

Comparative Industry Growth

The accompanying table ranks 30 major industry categories, including government enterprises, by the expected trend growth of product shipments in producer prices to 1985. These have been classified according to relative growth prospects, viz., faster, moderate, or slower growth. Although the categories are somewhat arbitrary, they appear to fit reasonably well with generally held perceptions of these industries. These growth rates were computed with the aid of an interindustry forecasting model (INFORUM) based on an input-output approach to the economy. The forecast is consistent with the long-term aggregate forecast presented in the preceding section of the *Economic Report* and provides insights into relative growth prospects.

This industry forecast differs from last year's (1978–1984) in several key respects. First, the level of growth rates is lower, in line with the lower real GNP forecast. Secondly, as a result of changes in sectoral share estimates and relative prices, a number of relative rankings have shifted dramatically. For instance, communications, ordnance, leather, apparel, and textiles have risen considerably, whereas rubber and plastics, transportation, metals and metal products, government enterprises, food, and petroleum have dropped in the rankings. Since growth of real product shipments is not necessarily correlated with profits, these results should not be misinterpreted as implying anything about future financial results.

COMPARATIVE INDUSTRY GROWTH
Product Shipments in Producer Prices
1979–1985

	Annual Trend Growth Rates
Faster Growth	
Communications	4.8%
Instruments	4.4
Electrical Machinery	4.4
Rubber and Plastics	4.2
Ordnance	4.0
Chemicals	4.0
Leather	3.8
Transportation Equipment	3.6
Non-electrical Machinery	3.5
Moderate Growth	
Trade	3.2
Apparel	3.1
Misc. Manufacturing	3.1
Textiles	3.0
Transportation	3.0
Financial Services	2.7
Metal Products	2.7
Furniture	2.7
Stone, Clay, Glass	2.7
Paper	2.7
Lumber	2.7
Metals	2.6
Slower Growth	
Printing and Publishing	2.3
Government Enterprises	2.1
Food	2.1
Construction	2.0
Agriculture	1.5
Tobacco	1.3
Mining	1.0
Utilities	0.9
Petroleum	-0.1

Source: SPNB forecast based on INFORUM Model.

In the faster growth category such industries as communications, instruments, electrical machinery, plastics, ordnance, and chemicals appear to have favorable prospects. Industries such as trade, transportation, financial services, paper, lumber, and metals are categorized as moderate growth, or roughly in line with the economy. Slower growth industries include such basic industries as construction, agriculture, mining, utilities, and petroleum.

Investment Sector Analysis

In the preceding section, 200 individual industries, defined in accordance with the Standard Industrial Classification (S.I.C.) codes, were aggregated into 30 major economic categories and then ranked in order of forecasted growth rates over the 1979–1985 period. In this section, however, a forecast is presented on the basis of categories that approximate the industrial breakdown of a broad stock market index, the Standard and Poor's 500 stock average. The specific S&P 500 industry categories are then grouped into ten functional groups according to past stock market behavior: consumer discretionary – durables; consumer discretionary – non-durables and services; consumer non-discretionary – non-durables; utilities; capital spending; technology; financial; energy; industrial commodity; and retail.

The accompanying table presents a forecast of real growth and prices for the ten investment groups and their major sub-groups of the 1979–1985 period. The right-hand column of the table indicates the relative weighting of each category in the S&P 500 as of December 31, 1979. Again, the results do not necessarily imply anything about relative profitability or market price performance for these industries.

In terms of real output growth, the groups expected to exceed the trend growth rate of real GNP include: technology; consumer discretionary – non-durables and services; capital spending; consumer discretionary – durables; and industrial commodity. Groups expected to grow in line with real national output include: financial; retail; and utilities. Lagging real growth of GNP are consumer non-discretionary – non-durables and energy.

However, there are some major differences within these broad groupings. For instance, drug & medical supplies, 4.7 percent, grows much faster than consumer non-discretionary – non-durables; telecommunications, 5.2 percent, exceeds utilities; aerospace, 5.0 percent, dominates capital spending; oil well machinery, 4.0 percent, far exceeds energy; and chemicals, 4.0 percent, leads industrial commodity.

INDUSTRY FORECAST BY INVESTMENT SECTORS
PERCENTAGE TREND GROWTH OF PRODUCT SHIPMENTS
1979–1985

	Real Growth (%)	Prices (%)	S&P 500 Weights 12/31/79
Consumer Discretionary – Durables	**3.1**	**8.7**	**6.4%**
Automobile	3.0	8.6	2.7
Automobile Parts	3.1	9.7	1.1
Building Materials	2.8	8.6	1.2
Household Appliances	4.2	7.4	.5
Textile & Apparel	3.1	9.2	.7
Tire & Rubber Goods	3.5	8.6	.3
Consumer Discretionary – Non-durables & Services	**3.3**	**8.4**	**7.5**
Brewers & Distillers	4.2	6.2	.8
Cosmetics & Toiletries	4.2	8.8	.9
Photography	5.4	8.8	1.2
Publishing	2.3	8.5	1.0
Soft Drinks	4.3	8.2	1.0
Air Transportation	4.0	8.8	.4
Hotel-Motel & Restaurants	4.3	7.8	.7
Leisure Time	1.6	8.9	1.5
Consumer Non-Discretionary – Non-durables	**2.2**	**9.4**	**11.7**
Containers – metal & glass	3.2	8.1	.4
Drug & Medical Supplies	4.7	7.7	5.8
Food & Allied Products	1.7	10.0	2.8
Soaps	4.2	8.8	1.4
Tobacco & Allied Products	1.3	7.7	1.4
Utilities	**2.5**	**8.8**	**11.9**
Telecommunications	5.2	6.1	6.0
Utilities – electric	2.2	9.3	3.6
Utilities – natural gas	-1.8	13.1	2.4
Capital Spending	**3.2**	**8.0**	**10.0**
Aerospace	5.0	7.2	2.6
Electrical Equipment	3.3	8.3	2.9
Machinery, General	3.3	8.3	2.8
Transportation	1.0	8.2	1.6
Technology	**5.2**	**7.7**	**10.7**
Electronics	5.6	7.6	1.9
Miscellaneous	–	–	1.0
Office Equipment	4.0	7.4	7.8
Financial	**2.6**	**9.0**	**5.8**
Banks and Finance Companies	2.6	8.3	3.5
Insurance	2.5	9.8	2.3
Energy	**.2**	**21.0**	**22.7**
Machinery – oil well	4.0	7.9	3.6
Oils – domestic & international	-.3	22.4	19.1
Industrial Commodity	**3.1**	**9.3**	**10.4**
Chemical & Allied Products	4.0	11.2	3.8
Forest Products	2.6	8.4	1.4
Metals & Mining	2.7	8.6	4.0
Paper & Paper Containers	2.7	8.2	1.2
Retail	**2.6**	**5.9**	**3.0%**
			100.0%

Demographics, Labor Force, and Employment

Women to take a more active role in mangement in the eighties. Pat Caswell, vp, personnel, Security Pacific Bank (left), Luz Maria Salazar R.N., St. Vincent's Hospital, L.A.

DEMOGRAPHIC OVERVIEW

The demographic aspects of economic growth are so basic and pervasive as to be sometimes overlooked. The rate of growth of population and its changing composition impact the labor force, housing, autos, and educational spending, just to mention a few areas. The forecasts on labor force and employment found in this report are based on the Bureau of the Census Series II population projection. This assumes that the fertility rate will return to its long-run replacement level of 2.1 from the current level of 1.7. Annual population growth has averaged 1.2 percent over the past 25 years. Since 1970 it has slowed to 0.8 percent. It is expected to accelerate moderately in the early 1980's and then return to about 0.8 percent by the end of the decade.

Baby Boom Influence

A dominant factor determining economic trends has been the influence of the population bulge known as the baby boom of the post-World War II period. As this large age group matured, a groundswell of demand was created – successively – for rattles, classrooms, and – currently – new homes. Assimilating this large age group is an important influence in today's economy. With the fast growth in the 25–34 age group during the recent past, the economy has witnessed strong demands for housing, for the goods to furnish these households, and for the credit to finance these purchases. By the mid-1980's the baby-boom age group will be swelling the 35–44 age group, traditionally a more conservative spending category of the population. This maturing

CIVILIAN NONINSTITUTIONAL POPULATION
Annual Percent Changes

	1970-79	1979-85	1985-90
Male			
16-19	1.5%	-2.8%	-1.2%
20-24	3.7	-0.1	-2.8
25-34	3.9	2.3	0.6
35-44	1.0	4.0	3.2
45-54	-0.1	-0.3	2.4
55-64	1.5	0.7	-0.8
65 +	1.9	1.6	1.7
Men – 16 & over	1.9	1.1	0.8
Female			
16-19	1.2	-2.6	-1.2
20-24	2.1	-0.1	-2.7
25-34	3.7	2.2	0.6
35-44	1.0	3.7	3.1
45-54	-0.2	-0.4	2.4
55-64	1.4	0.5	-1.0
65 +	2.6	1.9	1.8
Women – 16 & over	1.8	1.1	0.8
Total	1.8%	1.1%	0.8%

Source: Based on BLS data.

should take some pressures off the housing market and durable goods spending.

LABOR FORCE OUTLOOK

In 1979 the average civilian labor force stood at 102.9 million persons. By 1985 the total is expected to reach 114.7 million, a net increase of 11.5 percent over the six-year period, or a 1.8 percent annual trend growth rate. This will represent a considerable slowing from the torrid 2.5 percent rate of the past decade, but is still a fairly healthy growth rate in the longer-term perspective of United States history. From 1985 to 1990, the pace should slow further to about a 1.2 percent rate, bringing the total labor force to about 121.6 million persons at the end of the decade.

Population Growth

For any given period of time, a certain percentage of the total population is actively seeking employment in the monetized sector of the economy. This group constitutes the active labor force. The percentage of this group unable to find suitable employment is referred to as the unemployment rate. Thus, it is self-evident that the size of the population is a major determinant of the civilian labor force. From 1970 to 1979 the total civilian noninstitutional population grew at a 1.8 percent trend rate, with the largest growth occurring in the 20 to 34 age group. However, population trends in the 1980's are likely to be considerably different. From 1979 to 1985 the total civilian noninstitutional population will grow at only a 1.1 percent trend rate. The central age group, 35 to 44, will experience relatively larger growth, while the teenage and young adult groups will actually decline. From 1985 to 1990 civilian noninstitutional population growth will decelerate further to about 0.8 percent.

As a consequence of the birthrate drop of the 1960's, an important feature of the 1980's will be the sharp decline in the number of youths 16 to 24 years of age. The total civilian noninstitutional population, 16 years and over, should grow by an estimated 24.5 million, or 17.9 percent, from 1970 to 1979, but it is projected to grow by only 11.4 million, or 7.1 percent, from 1979 to 1985, and by 7.3 million, or 4.2 percent, from 1985 to 1990. While the teenage ranks will be thinner, population in the central age groups will be swollen by further aging of the many millions born in the post-World War II baby boom.

CIVILIAN LABOR FORCE PARTICIPATION RATES
(Annual Averages, Percent of Population in Labor Force)

			SPNB Forecast	
	1970	1979	1985	1990
Male				
16-19	56.1%	61.7%	63.6%	64.8%
20-24	83.3	86.6	87.0	88.0
25-34	96.4	95.4	95.0	95.0
35-44	96.9	95.8	96.0	95.0
45-54	94.2	91.4	90.5	90.0
55-64	83.0	73.0	69.5	68.0
65 +	26.8	20.0	18.0	16.0
Men – 16 & over	79.7	77.9	77.9	77.5
Female				
16-19	44.0	54.5	62.0	65.0
20-24	57.7	69.1	78.0	82.0
25-34	45.0	63.8	74.0	80.0
35-44	51.1	63.6	71.0	76.0
45-54	54.4	58.4	60.0	62.0
55-64	43.0	41.9	41.0	40.0
65 +	9.7	8.3	7.2	6.6
Women – 16 & over	43.3	51.0	55.9	58.4
Total	60.4%	63.7%	66.3%	67.5%

Source: BLS; SPNB forecast

Participation Rates: The Critical Variable

One of the most troublesome variables to forecast in recent years has been the labor force participation rate. Most public as well as private forecasters estimate an increase in the participation rates among most population groups, but especially among women. The data presented in this report, although partly based on a revised set of projections from the Bureau of Labor Statistics, were revised upward by SPNB in the light of more recent evidence. A further rise in the participation rates of both male and female teenagers is expected due to a number of factors, including: decelerating college enrollments, greater economic pressures on households, and changing lifestyles. Further gains in labor force activity are also expected among women in the central age group. On the other hand, older workers, despite a lengthening of the mandatory retirement age to 70, are expected to opt for earlier retirement and leisure activities.

The overall civilian labor force participation rate is projected to rise from 63.7 percent in 1979 to 67.5 percent by 1990. The rate for all men is expected to decline slightly over the period, and the rate for all women is expecteed to continue rising.

CIVILIAN LABOR FORCE
(millions)

	1970	1973	1979	SPNB Forecast 1985	SPNB Forecast 1990
Male					
16-19	4.0	4.7	5.0	4.4	4.2
20-24	5.7	7.1	8.2	8.2	7.2
25-34	11.3	12.8	15.8	18.1	18.6
35-44	10.5	10.3	11.3	14.3	16.6
45-54	10.4	10.4	10.1	9.7	10.9
55-64	7.1	7.0	7.1	7.1	6.7
65 +	2.2	1.9	1.9	1.9	1.9
Men – 16 & over	51.2	54.2	59.5	63.7	66.1
Female					
16-19	3.2	3.8	4.5	4.4	4.3
20-24	4.9	5.6	7.0	7.9	7.2
25-34	5.7	7.2	11.2	14.8	16.5
35-44	6.0	6.1	8.1	11.3	14.1
45-54	6.5	6.6	6.9	6.9	8.0
55-64	4.2	4.2	4.6	4.6	4.3
65 +	1.1	1.1	1.1	1.1	1.1
Women – 16 & over	31.5	34.5	43.4	51.0	55.5
Total	82.7	88.7	102.9	114.7	121.6

Source: Bureau of Labor Statistics; SPNB forecast.

ANNUAL RATES OF CHANGE IN LABOR FORCE

	1970-79	1973-79	1979-85	1985-90
Male				
16-19	2.6%	1.3%	-2.2%	-0.9%
20-24	4.2	2.6	–	-2.6
25-34	3.8	3.5	2.3	0.5
35-44	0.9	1.7	4.0	3.0
45-54	-0.4	-0.6	-0.6	2.4
55-64	–	0.3	–	-1.2
65 +	-1.3	0.2	–	–
Men – 16 & over	1.7	1.6	1.1	0.7
Female				
16-19	3.7	2.8	-0.4	-0.5
20-24	4.2	3.9	2.0	-1.8
25-34	7.8	7.6	4.8	2.2
35-44	3.5	4.8	5.7	4.5
45-54	0.5	0.8	–	3.0
55-64	1.1	1.5	–	-1.3
65 +	0.9	1.4	–	–
Women – 16 & over	3.6	3.9	2.7	1.7
Total	2.5%	2.5%	1.8%	1.2%

Changing Composition of the Labor Force

The accompanying tables illustrate the size of the projected labor force by 1985, annual rates of change for several sub-periods, and the changing composition of the labor force over time.

As a result of these expected changes, several general implications can be drawn. Some improvement is expected in the employment situation of youths. Because of the decline in this age category, there should be a lessening of competition for jobs and a narrowing in the relative gap in unemployment rates between teenagers and other groups. This decline, however, does not augur well for traditional youth market industries and will have a negative impact on college enrollments.

The maturing of the labor force should lead to a more productive labor force. The greater productivity of a more experienced workforce should partially offset the slower labor force growth in the 1980's. The impact of more women in the labor force is ambiguous and will depend on the extent to which women with children will be able to work full time.

The so-called "economic dependency ratio," i.e., the ratio of nonworkers to workers in the entire population, is expected to fall during the 1980's. In 1977 the ratio was 117.8, meaning there were 117.8 nonworkers for every 100 workers in the population. This ratio is expected to decline to below 100 by 1990. However, this ratio should reverse itself again after the year 2000, when post-World War II babies begin to reach retirement age.

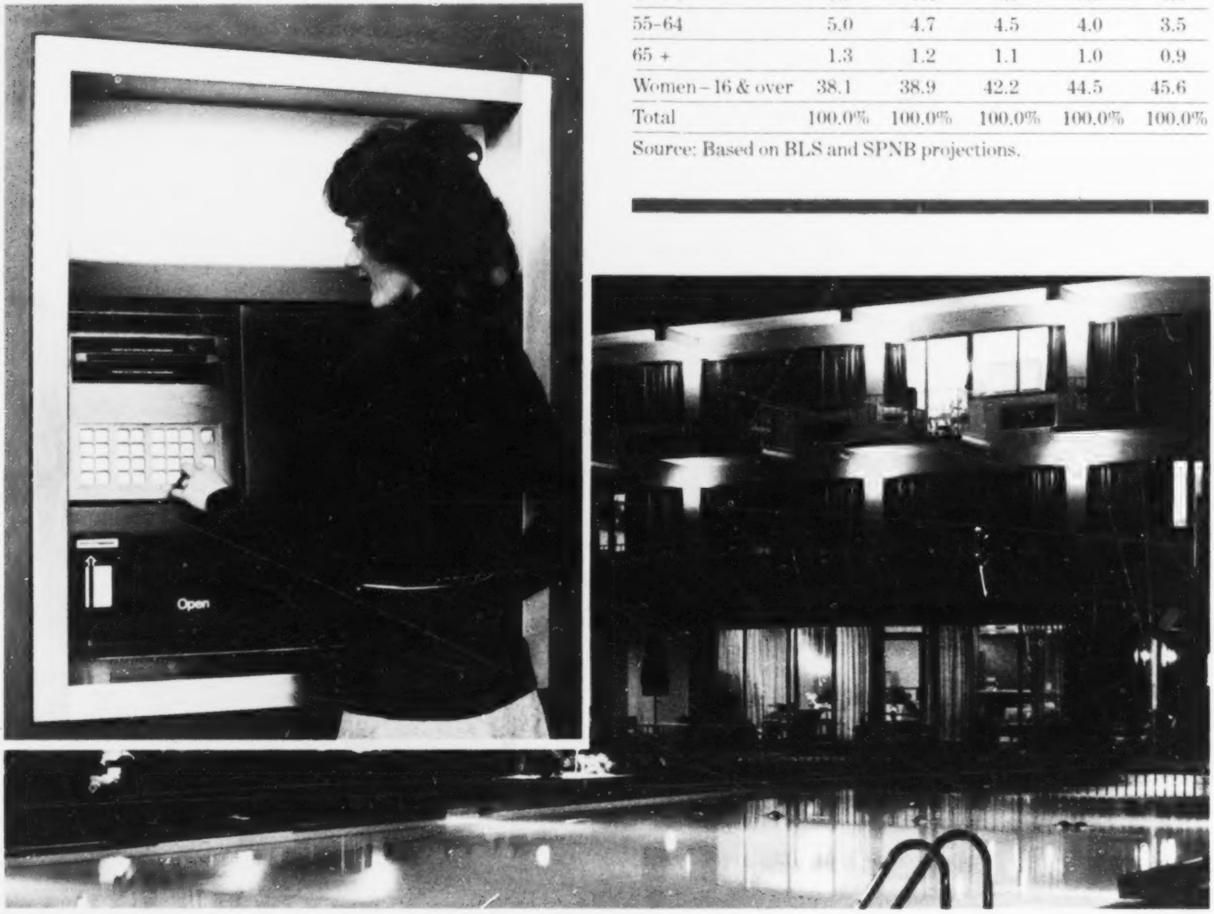
EMPLOYMENT OUTLOOK

The difficulties that the economy seems likely to encounter in achieving full employment by 1985 were suggested in the long-term macroeconomic forecast earlier in this *Economic Report*. The full-employment unemployment rate (F.E.U.R.) was projected to be about 5.5 percent by 1985. However, it was assumed that the economy would be hard-pressed to achieve even this goal and that a more realistic range would be an actual unemployment rate in the 7.0–7.5 percent range.

COMPOSTION OF CIVILIAN LABOR FORCE
(Percentage Shares)

	1970	1973	1979	1985	1990
Male					
16–19	4.8%	5.3%	4.9%	3.8%	3.5%
20–24	6.9	8.0	8.0	7.1	5.9
25–34	13.7	14.5	15.3	15.8	15.3
35–44	12.7	11.6	11.0	12.5	13.7
45–54	12.6	11.8	9.8	8.5	9.0
55–64	8.6	7.9	6.9	6.2	5.5
65 +	2.6	2.2	1.9	1.7	1.6
Men – 16 & over	61.9	61.1	57.8	55.5	54.4
Female					
16–19	3.9	4.3	4.4	3.8	3.5
20–24	5.9	6.3	6.8	6.9	5.9
25–34	6.9	8.1	10.9	12.9	13.6
35–44	7.2	6.9	7.9	9.9	11.6
45–54	7.9	7.4	6.7	6.0	6.6
55–64	5.0	4.7	4.5	4.0	3.5
65 +	1.3	1.2	1.1	1.0	0.9
Women – 16 & over	38.1	38.9	42.2	44.5	45.6
Total	100.0%	100.0%	100.0%	100.0%	100.0%

Source: Based on BLS and SPNB projections.



Above, continued employment growth in financial services;
Below, condominium living—an alternative to home buying and apartment living.

Where Will the Jobs Be?
The accompanying table summarizes the historical growth trends of full-time employment in private industry by 29 broad industrial categories. It presents both a longer-term historical view of employment growth, 1958 to 1979, as well as the more recent and difficult 1973-1979 period. The major area that stands out in terms of both size and consistently strong growth is the area of finance and services.

The 1979-1985 employment forecast is based upon the long-term outlook presented in this report, with the aid of the INFORUM interindustry forecasting model. In terms of relative shares of full-time employment, finance and services will continue to expand. Ordnance is expected to rebound sharply over the forecast period.

Industries of declining shares of employment from 1979 to 1985 are expected to be agriculture, chemicals, transportation, utilities, and trade.

FULL-TIME EMPLOYMENT IN PRIVATE INDUSTRY GROWTH AND COMPOSITION
1979-1985

	Annual Trend Growth Rates			Percentage Share	
	1958-79	1973-79	1979-85F	1979E	1985F
Agriculture	-2.3%	-0.6%	-1.5%	4.1%	3.4%
Mining	0.6	3.9	2.2	1.0	1.0
Construction	2.0	0.9	1.7	6.4	6.4
Ordnance	-1.0	-3.9	4.6	0.2	0.2
Food	-0.2	-0.1	0.9	2.1	2.0
Tobacco	-1.5	-1.7	-1.0	0.1	0.1
Textiles	-0.2	-2.4	1.8	0.9	0.9
Apparel	0.6	-1.4	0.6	1.9	1.8
Lumber	1.0	-0.3	0.6	0.8	0.8
Furniture	1.2	-0.8	2.5	0.7	0.7
Paper	1.0	-0.1	0.8	0.9	0.8
Printing and Publishing	1.5	1.6	0.7	1.5	1.4
Chemicals	1.6	1.8	0.2	1.4	1.2
Petroleum	-0.3	2.1	-0.2	0.3	0.2
Rubber and Plastics	4.2	2.2	2.5	1.0	1.0
Leather	-1.6	-2.6	3.0	0.3	0.4
Stone, Clay, Glass	1.2	0.4	0.9	0.9	0.8
Metals	0.7	-0.1	0.6	1.6	1.5
Metal Products	2.3	2.1	1.7	2.0	2.0
Non-electrical Machinery	2.7	2.0	1.4	3.0	2.9
Electrical Machinery	2.3	0.3	1.2	2.6	2.5
Transportation Equipment	0.6	1.3	0.5	2.5	2.3
Instruments	3.6	3.5	2.1	0.8	0.8
Misc. Manufacturing	1.1	1.6	-0.9	0.6	0.5
Transportation	0.6	0.7	0.4	3.9	3.6
Communications	1.8	0.8	0.5	1.5	1.4
Utilities	1.2	0.9	-0.6	1.0	0.8
Trade	1.5	1.8	0.8	26.2	24.7
Finance and Services	3.4	3.5	3.7	30.1	33.8
				100.0%	100.0%

E = INFORUM estimates F = SPNB forecast

The Productivity Dilemma

Wheat Harvesting

THE PRODUCTIVITY LAG

From 1950 to 1979 the average annual growth rate of productivity, i.e., output per hour in the nonfarm business sector, was 1.9 percent. However, from 1950 to 1973, it averaged 2.3 percent, then dropped to 0.5 percent from 1973 to 1979. Because of the crucial importance of productivity as it affects our standard of living, real incomes, and the rate of inflation, the debates over the causes of the phenomenon have been intense.

The noted economist, Edward F. Denison, has attempted to measure the causes of the decline in productivity. However, the use of his production function approach in measuring the sources of economic growth has produced ambivalent results. The largest component of the negative net change in productivity is attributed to a residual category, "advances in knowledge and miscellaneous determinants." Thus, the most comprehensive attempt to measure the factors contributing to the decline ends up with a large "unexplained" residual.

The Major Causes of the Decline

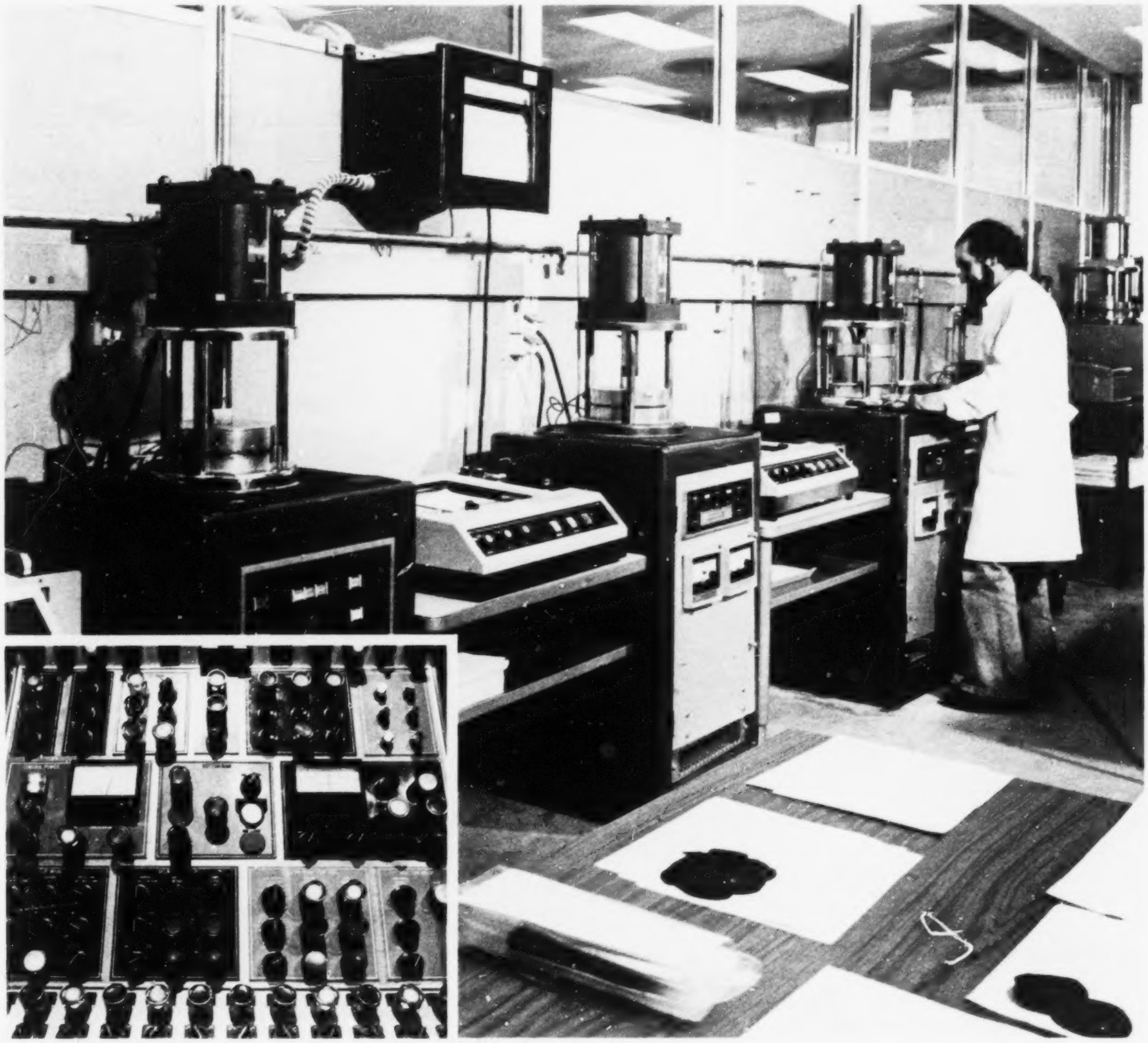
Although it has proven extremely difficult to explicitly quantify the causes of the productivity lag, a number of contributing factors can be identified. Investment in plant and equipment by private business, for a host of reasons, has lagged the economy since 1973. Most measures of the capital stock imply a decline in the capital-labor ratio. Much of the investment that has occurred since the 1960's has been consumed by regulatory costs, pollution abatement and control equipment, and other such necessary but "nonproductive" investment. Plant and equipment conversion due to higher energy costs has further aggravated the situation since 1973.

The other major causes usually enumerated include: the lag in research and development expenditures since the late 1960's; the changing structure of the economy, viz., the shift into the lower productivity service sector out of higher productivity manufacturing; the rise of inexperienced women and youths in the labor force; the extremely severe cyclical pattern of the economy in the 1970's; and tax policies which have hampered saving and investment.

The Fundamental Reasons

The root causes of the phenomenon, however, appear to narrow down to three areas: marginal productivity of labor, energy cost increases, and unanticipated inflation. The traditional economic reasoning of marginal productivity theory sheds light on this issue which is often confused by discussing "average" productivity trends. With a given amount of capital and resource inputs, together with a relatively stable state of technology, additional inputs of labor will produce more output, but at a diminishing rate. It appears that, in recent years, the rapid growth of the labor force has led to a situation of small to perhaps negative marginal productivity of labor, which, in turn, has dragged down the average productivity of labor. Not only the size of the increment to the labor force, but its relative inexperience, i.e., women and youths, lends credence to the negative marginal productivity explanation.

The unexpected rapid rise in energy costs has led to a painful period of resource reallocation due to both short- and longer-term inelasticities, e.g., inelasticity of energy demand with respect to real GNP, supply inelastici-



Laboratory—Monsanto Co.

ties of alternative energy sources, and inelasticities of substitution between competing fuels. The net effect has been an obsolescence of a substantial part of the nation's capital stock. Furthermore, longer-term resource allocation decisions have been hampered by the fact that a comprehensive federal energy policy has been slow in developing.

Finally, the inflationary experience of the 1970's has created further distortions in the price system, thus hampering the market's response in handling resource reallocation efficiently. High interest rates have added greater uncertainty to the capital budgeting process in private industry and, of course, have substantially raised the nominal cost of capital to the firm.

PRODUCTIVITY OUTLOOK

Despite its dismal history since 1973 and even bleaker near-term outlook, productivity is expected to recover somewhat in the 1980's. Over the 1979–1985 forecast period, productivity growth should average about 1.4 percent annually. From 1985 to 1990, it should improve beyond that to perhaps closer to the 2.0 percent area.

The reasons for this guarded optimism are several. A cyclical recovery of the economy should bolster productivity from 1981 on. The expected slowdown in labor force growth should lead to some improvement in average productivity, via a reversal of the negative marginal productivity argument, and reinforced by the maturing of the labor force. There has been a recent pick-up in research and development spending and this trend should gain impetus from increased spending on aerospace and defense.

An above-trend growth in business spending on plant and equipment over the forecast period should gradually improve the capital-labor ratio. In addition, the share of investment dollars devoted to environmental, health, and safety expenditures by industry should be declining in the 1980's. Industrial adjustment to high energy costs since 1973 will begin to assert itself as newer, energy-efficient technologies become more widespread. There also appears to be much more political support for granting greater tax incentives for business investment as public policy seeks ways of overcoming the productivity dilemma.

Productivity Forecast by Industry

Although the productivity slowdown has been fairly widespread, it has not been universal. The accompanying table shows the productivity history for private industry classified into 29 industrial sectors. The longer-term history, 1958 to 1979, is presented, along with the more recent period, 1973 to 1979. Industries particularly hard hit include: mining; construction; rubber and plastics; stone, clay, glass; metals; metal products; trade; and services. Manufacturing industries have fared relatively better than nonmanufacturing.

The forecast for the 1979–1985 period is based on the long-term outlook, presented in this report, with the aid of the INFORUM interindustry model. Productivity is defined as output per employed person. Above-trend productivity industries include: agriculture; chemicals; electrical machinery; transportation equipment; and communications. Industries that are still expected to achieve negative productivity growth are: mining; ordnance; and finance and services.

PRODUCTIVITY OUTLOOK BY INDUSTRY

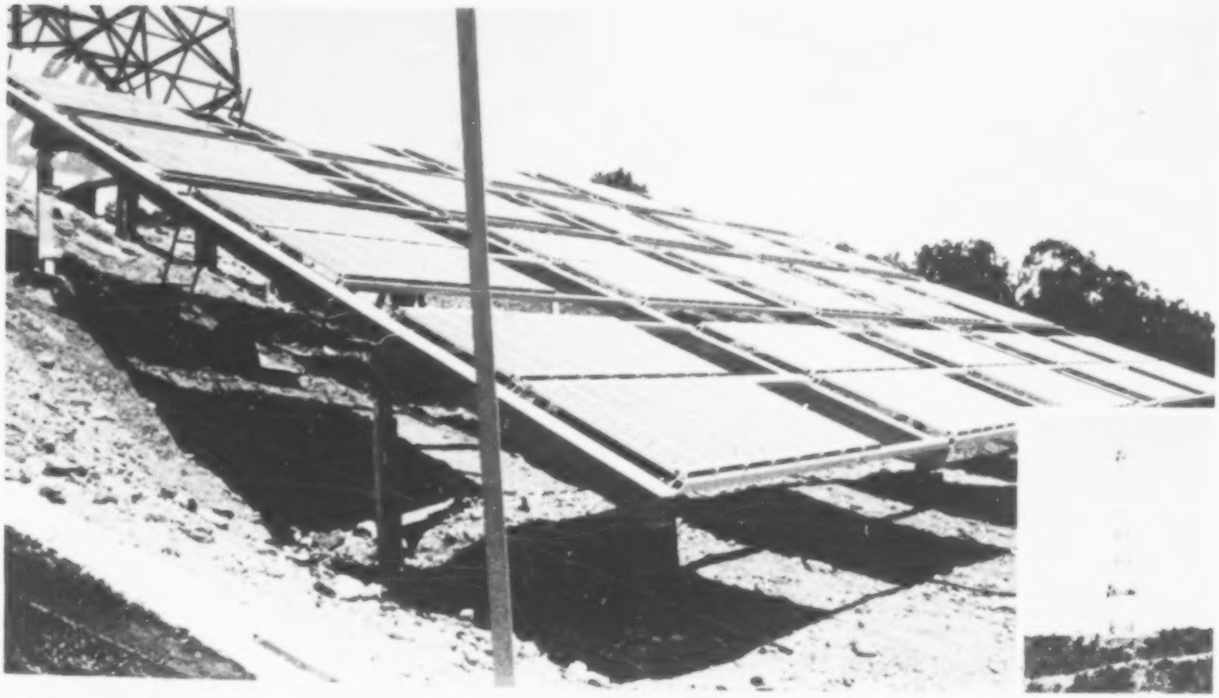
Output per Employed Person

(Annual Trend Growth Rates)

	1958–79	1973–79	1979–85F
Agriculture	4.4%	2.9%	3.0%
Mining	1.0	-5.6	-0.9
Construction	–	-3.1	0.2
Ordnance	1.8	2.0	-0.6
Food	2.6	2.6	1.3
Tobacco	2.5	2.1	2.3
Textiles	3.5	5.7	1.4
Apparel	3.0	2.5	2.7
Lumber	2.0	2.5	2.7
Furniture	2.4	1.1	0.2
Paper	2.7	1.6	1.9
Printing and Publishing	1.2	-0.3	1.7
Chemicals	4.2	1.0	3.8
Petroleum	3.6	2.3	0.1
Rubber and Plastics	1.9	-1.1	1.6
Leather	1.6	3.4	1.2
Stone, Clay, Glass	1.9	0.2	1.8
Metals	1.6	-1.1	2.1
Metal Products	1.3	-0.8	1.1
Non-electrical Machinery	2.3	0.7	2.4
Electrical Machinery	3.4	1.1	3.5
Transportation Equipment	3.0	0.5	3.5
Instruments	2.8	0.9	1.8
Misc. Manufacturing	2.7	0.3	3.9
Transportation	2.9	1.6	2.9
Communications	5.0	5.7	4.3
Utilities	3.2	1.4	1.4
Trade	2.5	0.9	2.4
Finance and Services	0.6	-0.4	-0.9

Source:
Based on INFORUM historical estimates and SPNB forecast.

Energy and Inflation



The world's longest telecommunication system is powered by solar energy. ARCO Solar, Inc., designed and installed the system.

ENERGY POLICY ASSUMPTIONS

It now appears that United States energy policy is inexorably headed in the direction of allowing domestic energy prices to rise to world price levels. Government policy will attempt to partially offset some of the burdensome impacts on income distribution by means of tax policies, including the so-called "windfall profits" tax bill. By allowing prices to rise, competing energy sources will eventually become more attractive and the reliance on imported petroleum will diminish. However, the cost will be indeed great.

Data Resources, Inc. has estimated that the elasticity of energy demand with respect to real GNP is about 0.65. Over the 1979–1985 forecast period, a 2.6 percent real output growth rate implies about a 1.7 percent annual average rate of total energy demand. However, effective demand is likely to be somewhat below the 1.7 percent rate. OPEC marker crude appears likely to climb at about a 16.7 percent average rate over the period. Decontrolled domestic crude should climb at about a 24 percent average rate, composite wellhead price, through 1985. It is assumed that domestic crude's share of total consumption will remain about one half.

INFLATION OVERVIEW

The overall rate of inflation, as expressed by the deflator of Gross National Product, is expected to average about 8.4 percent through 1985, compared to the 7.7 percent average for the 1973–1979 period. The rate of increase in both 1980 and 1981 is expected to exceed 9 percent. By 1985 the rate of increase is forecasted to drop to about the 7.5 percent area. The accompanying

INFLATION OUTLOOK
GNP COMPONENT DEFLATORS
1979–1985

	Annual Trend Growth Rates 1973-79	1979-85F
Gross National Product	7.7%	8.4%
Personal Consumption Expenditures	7.6	8.3
Durable Goods	6.1	6.7
Autos and Parts	7.5	7.8
Except Autos and Parts	5.1	5.9
Nondurable Goods	8.0	8.4
Services	7.7	8.7
Gross Private Domestic Investment	9.2	8.9
Fixed Investment	9.2	8.9
Nonresidential	8.7	8.4
Producers' Durable Equipment	8.0	7.8
Structures	10.2	9.5
Residential	10.5	10.2
Change in Businesss Inventories	8.8	8.8
Government Purchases	8.5	8.8
Federal	8.0	8.6
State and Local	8.7	9.0
Exports	10.8	8.8
Imports	13.7	10.0

table provides annual trend growth rates of inflation by detailed components of GNP, for the 1973–1979 period as well as the forecasted rates for 1979–1985. The differential impacts of inflation result in real personal consumption being squeezed by the other three sectors – investment, government, and net exports.

Major factors contributing to inflation over the 1979–1985 forecast period include energy costs, food and other commodity costs, sluggish productivity performance, increased federal expenditures on defense, unit labor costs (expected to grow at about an 8.2 percent rate), high import prices permeating the domestic economy, and a greater proportion of real output devoted to exports at the sacrifice of domestic consumption.

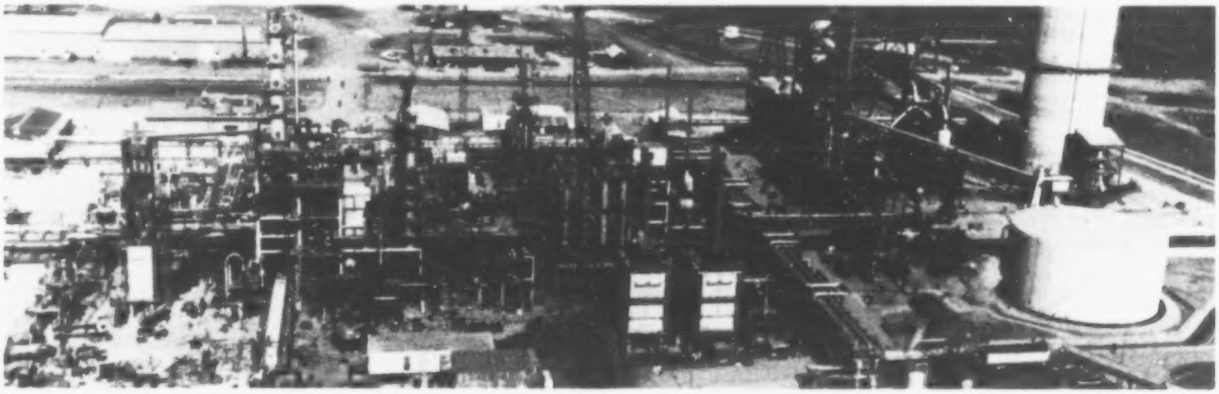
Other Inflation Indicators

Currently the most visible indicator of a rising price level in the economy is the Consumer Price Index, which has been rising at a faster rate than the GNP deflator. Using a market basket approach, it has been particularly sensitive to cost increases at the margin for food, fuels, and housing. This discrepancy between the CPI and the deflator is likely to persist for several years before converging again. Thus the average rate over the 1979–1985 period for the CPI is expected to be near 9 percent versus 8.4 percent for the GNP deflator.

Wholesale prices are also expected to increase at a faster rate than the GNP deflator, aggravated especially by the fuels component. Overall, the WPI is expected to increase at about a 9.7 percent annual average rate. The accompanying table provides estimates of expected wholesale price performance, over the 1979–1985 period, for 30 industrial sectors including government enterprises. Wholesale prices are led by petroleum, mining, agriculture, and utilities and are generally lower in manufacturing and trade.

An Appraisal

The risks to an inflation forecast are numerous. However, assuming reasonably firm monetary and fiscal policies and just a tolerable amount of external shocks over the 1979–1985 period, there is cause for some optimism that the base rate of inflation can be brought down to about the 7.5 percent area by 1985. Many of the factors



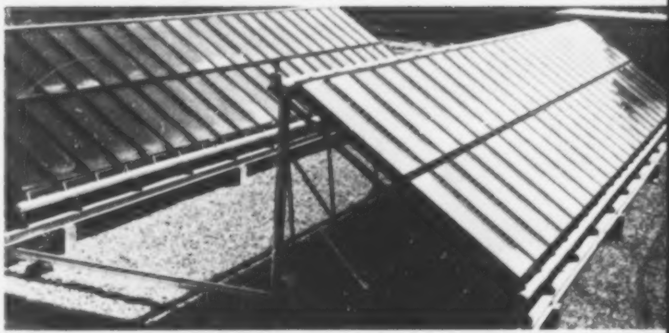
Exxon's new coal liquefaction pilot plant in Baytown, Texas.

contributing to the current inflationary surge should be easing or improving beyond 1981. Energy prices should ease somewhat and the nation's energy policy should begin to have more impact as we go further out in the 1980's. Food and commodity prices should be easing based on cyclical factors. But the major cause of improvement should come from the expected rebound in productivity. However, all favorable prospects dissipate if monetary and fiscal policies validate the inflation instead of pursuing restraint.

WHOLESALE PRICE OUTLOOK BY INDUSTRY 1979–1985

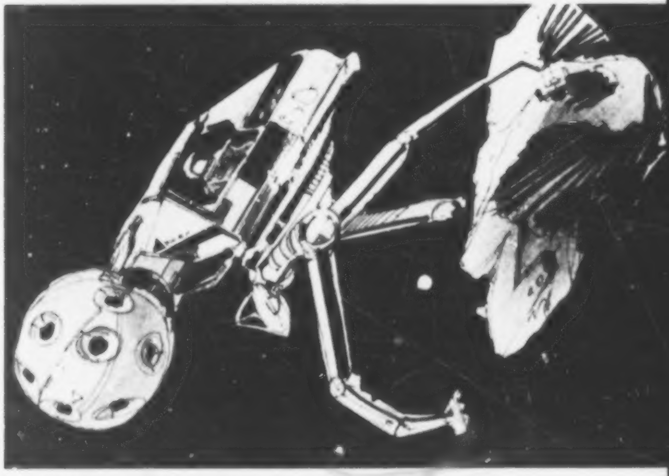
	Annual Trend Growth Rates
Agriculture	10.5%
Mining	11.6
Construction	7.3
Ordnance	8.8
Food	9.2
Tobacco	7.4
Textiles	9.5
Apparel	8.2
Lumber	7.9
Furniture	8.6
Paper	7.9
Printing and Publishing	8.1
Chemicals	9.9
Petroleum	18.1
Rubber and Plastics	9.7
Leather	7.1
Stone, Clay, Glass	7.9
Metals	8.0
Metal Products	8.3
Non-electrical Machinery	7.9
Electrical Machinery	7.7
Transportation Equipment	7.7
Instruments	8.6
Misc. Manufacturing	8.0
Transportation	8.3
Communications	6.3
Utitilities	10.4
Trade	5.8
Finance and Services	8.3
Government Enterprises	9.2

Source: SPNB forecast based on INFORUM Model.



Solar collector section of an absorption refrigeration machine that provides chilled water for air conditioning. Carrier Corp.

Eagle Butte Mine—AMAX Coal Co.



A vehicle designed to probe outer space and retrieve small asteroids and floating fragments for processing by a solar powered smelting station. (By Thomas Van Kirk Peters—Art Center College of Design, Pasadena, California)

The California Economy in 1985

Californians buy more pools, spas, and other leisure products.

California's pattern of economic growth during the post-World War II era has differed in several major respects from the national pattern. An understanding of the prospects for continued growth in the California economy involves some discussion of these divergent trends, since the national long-run outlook does not explicitly consider the importance of regional differences.

Demographic variables are probably the most important components of a regional long-range projection, since population size, household formation rates, fertility rates, age distribution, and related variables help determine the aggregate demand for goods and services and, in conjunction with the capital stock, the aggregate supply or "potential" economic output as well. Due to a tendency toward regional specialization, regions are not as self-contained as the nation, and thus "leakages" of labor and capital take on greater importance at the regional level. In California, those leakages have for the most part taken the form of capital imports, or net in-migration of massive numbers of new residents from other states and foreign countries.

THE DECADE OF THE SEVENTIES

During the period beginning about 1970, California matured considerably as a major national and international capital market. The historical interest rate differentials, once considered necessary to lure funds from outside the state to augment the shortage of internally generated funds, began to shrink with the increasing self-sufficiency of the state's own financial markets. During 1967, it was estimated that over 21 percent of savings balances held by insured California savings and loan associations originated outside of the state. By 1977, the out-of-state proportion had fallen to less than 5 percent.

It appeared during the early 1970's that California's labor market had also become more self-sufficient. Inflows of new migrants to the state, which had averaged over 300,000 annually during the late 1950's and early 1960's, had slowed to a mere 45,000 by 1971. The slowing of migrant inflows during the early 1970's partly reflected a slowing of growth in job opportunities following the severe cutbacks in defense spending, which severely affected the California aerospace industry, where employment declined nearly 30 percent between 1967 and 1971. By 1977, however, the California aerospace industry had largely revived from its earlier slump, and found new sources of strength in production for both military and civilian end-use markets.

The renewed vitality of the state's aerospace industry since 1977 has been accompanied by vigorous employment growth in other key sectors such as residential and commercial construction; durable goods industries related to housing; transportation equipment other than aircraft; trade; services; and finance, insurance, and real estate activity.

The very rapid employment growth of the past three years, when the state added an estimated 1.5 million workers to nonagricultural payrolls, is believed to have included an unprecedented proportion of first-time workers whose productivity should initially be lower than that of experienced workers. While total personal income in the state grew very rapidly during that period, more limited data on average hourly earnings of production workers have shown little or no real gains, indicating that productivity may have dropped. Due to the unavailability of statewide data on *output* per hour per worker, productivity cannot accurately be measured, leaving us with only a strong surmise concerning its recent trend. It is clear, however, that the relatively low recent rate of productivity increase has assumed the proportions of a major national problem, and it is reasonable to assume that the same problem exists in California, although perhaps to a lesser extent in view of the state's generally newer and more productive capital stock. We are currently expecting employment growth in the state to slow considerably from the pace of the last three years, leading to a potential problem of rising unemployment in view of the relatively high migration assumed in the projections to 1985.

Net migration to California, which has been on an uptrend since its post-World War II low point in 1971, has averaged about 200,000 per year during the 1976–1979 period. The 1978 total of 217,000 net migrants was the highest total since 1964. It is our view that net migration is likely to continue to average about 200,000 annually during the 1979–1985 projection period. Natural increase, the net of births and deaths, has been contributing over 180,000 new Californians annually during the past three years. On average, a combined annual increase in population of about 370,000 is expected between 1979 and 1985, resulting in a 1985 total population of about 24.9 million for California.

PROJECTED EMPLOYMENT TRENDS

It is projected that the California civilian labor force will continue to expand at about the same average annual rate, 3.3 percent, during 1979–1985 as during the 1970–1979 period. That continued high rate of labor force growth is based not only on more rapid population gains, but also a continuation of the trend toward increased labor force participation of all groups, and especially, of women. The multi-wage-earner family appears to be on the way to becoming the typical economic unit in the state by the end of the 1980's, in response to inflation, low productivity growth, and a host of sociocultural factors. We are projecting that total civilian employment will increase at an average 3.2 percent an-

PROJECTIONS OF THE CALIFORNIA ECONOMY
SELECTED INDICATORS
1979–1985

				Average Annual Growth Rates	
	1970	1979	1985	1970–79	1979–85
Total Population (July 1, millions)	20,026	22,694	24,894	1.4	1.6
Civilian Labor Force (millions)	8,170	10,928	13,291	3.3	3.3
Civilian Employment (millions)	7,584	10,247	12,367	3.4	3.2
Unemployment (millions)	586	680	924	1.7	5.2
Unemployment Rate (percent)	7.2	6.2	7.0	–	–
Consumer Price Index, all urban consumers, Los Angeles (1967 = 100)	114.3	213.7	359.5	7.2	9.1
Personal Income ($ billions)	88.6	227.4	457.1	11.0	12.3
Real Personal Income (billions of 1967 $)	77.5	106.4	127.1	3.6	3.0

Racquetball – increasing in popularity among Californians.

nual rate from 1979 to 1985, down slightly from the average of the 1970–1979 period, and also slightly below the projected rate of growth in labor force. This overall rate of employment growth results in an increase in the unemployment rate from 1979's 6.2 percent to a 1985 level of 7 percent, which should be very close to the national reading in that year.

Industry Trends

Total nonagricultural wage and salary employment, which is basically a measure of the number of workers on nonfarm payrolls, is projected to increase at an average 3.4 percent annual rate during the 1979–1985 period compared with the 3.8 percent average gain of the past decade. The sectoral growth rates, displayed in the accompanying table, show some variance from the trends of the 1970's, reflecting California's continuing maturation and change as a regional economy. The state's relatively small mineral extraction industry should see a considerably higher average growth during the next five years due to increased economic incentives for development of petroleum reserves. Population pressures and rapid job growth should assure a continued strong demand for housing, at least 250,000 units annually by 1985, leading to continued gains in construction employment averaging 4.5 percent annually. Employment in finance, insurance, and real estate industries should increase about 4 percent in the next five years, down from the heady 5.3 percent average growth of the 1970's. The dominant trade and services sectors should continue to expand more rapidly than the average at annual rates of 3.7 percent and 4.6 percent for trade and services, respectively. The combined share of those two sectors in total payroll employment will increase to 46.5 percent, up from 44.5 percent in 1979 and 40.2 percent in 1970.

Manufacturing industry will account for a declining share of employment in California, as nationally, during the next five years, continuing the trend of the 1970's. Due to the projected strength of virtually all parts of the state's aerospace industry during the next five years, employment gains in the durable goods sector will proceed at a faster pace than during the 1970's. Aerospace employment is projected to increase at an average rate of 4.3 percent annually from 1979 to 1985. While no comparable aerospace employment data exist for the 1970–1979 interval, the industry's employment growth averaged a similar 4.4 percent per year from 1972 to 1979. The nondurable goods industries are expected to show rather weak growth in the 1980's, although a current slump that began in 1979 and is expected to last into 1981 has depressed job growth in nondurable goods manufacturing below what it should be by mid-decade.

Public sector employment trends illustrate the most interesting variance from past history. The federal government, which was the only major sector actually to lose jobs during the decade of the 1970's, is projected to increase modestly by 1985. State and local government, where employment increased at an average rate of 2.8 percent annually during the 1970's, is projected to grow only about 2 percent per year from 1979 to 1985, and even that projection is endangered by the continuing political influence of the state's "taxpayer revolt." In our view, it is unrealistic to expect declines or even, perhaps, stability in state and local government employment during an era when we expect population growth to create unprecedented demands for a wide range of public services. The issue, in the minds of some observers, is not just how much government we will have, but also how we will pay for it. Measures such as 1978's Proposition 13, 1979's Proposition 4 (the spending limitation), and 1980's Proposition 9 (the income tax cut), have affected, and will affect, the actual size of state and local govenment perhaps less than was envisioned by their most ardent supporters. Employment growth of much more than 2 percent per year is probably not feasible under the spending limitation mandated by Proposition 4 last year. The ultimate effect of the taxpayer revolt on state and local government employment may be illustrated most dramatically by contrasting our projected em-

CALIFORNIA NONAGRICULTURAL EMPLOYMENT
1979-1985
(thousands)

	1970	1979	1985	Average Annual Growth Rates 1970–79	Average Annual Growth Rates 1979–85
Total Nonagricultural Workers	6,948	9,683	11,844	3.8	3.4
Mining	31	39	50	2.6	4.2
Construction	303	463	603	4.8	4.5
Manufacturing	1,558	2,003	2,390	2.8	3.0
Nondurable Goods	514	643	701	2.5	1.4
Durable Goods	1,044	1,360	1,689	3.0	3.7
Aerospace	N.A.	570	735	N.A.	4.3
Transportation and Public Utilities	459	537	612	1.8	2.2
Trade	1,531	2,232	2,770	4.3	3.7
Finance, Insurance and Real Estate	374	597	753	5.3	3.9
Services	1,260	2,081	2,733	5.7	4.6
Government	1,425	1,730	1,933	2.2	1.9
Federal	327	321	335	–0.2	0.7
State and Local	1,098	1,409	1,598	2.8	2.1

ployment total of about 1.6 million in 1985 with some pre-1978 projections that ranged as high as 1.8 million, or 200,000 more than currently projected levels.

PERSONAL INCOME AND PRICES

Personal income in the state is projected to grow at an average rate of 12.3 percent per year between 1979 and 1985, up somewhat from the 1970–1979 average rate of 11 percent, but generally consistent with the pattern of increase in employment and inflation. The inflation rate, as measured by the Los Angeles CPI, is expected to increase at a significantly higher trend rate, 9.1 percent, than the 7.2 percent average rate between 1970 and 1979. Assuming that the inflationary experience of the state will not differ importantly from that of Southern California over the projection interval, real personal income should increase at an average rate of 3 percent per year between 1979 and 1985, down somewhat from the 3.6 percent average growth rate of 1970–1979.

SUMMARY AND CONCLUSION

California's pattern of economic growth during the 1970's has continued to display important differences from the national growth pattern. The state's position at the western terminus of the "sunbelt" grouping of states and its favorable situation as a focal point of international trade with the other nations of the Pacific Basin have become increasingly important to an understanding of western regional growth trends. The favorable climate, varied lifestyles, and strong industrial base offered by California have served to attract continuing inflows of labor and capital from other regions of the nation and from abroad. The state has been in the vanguard of the national "taxpayer revolt," and has already significantly reversed the previous trend in allocation of resources increasingly toward public uses, with further changes likely in the near future.

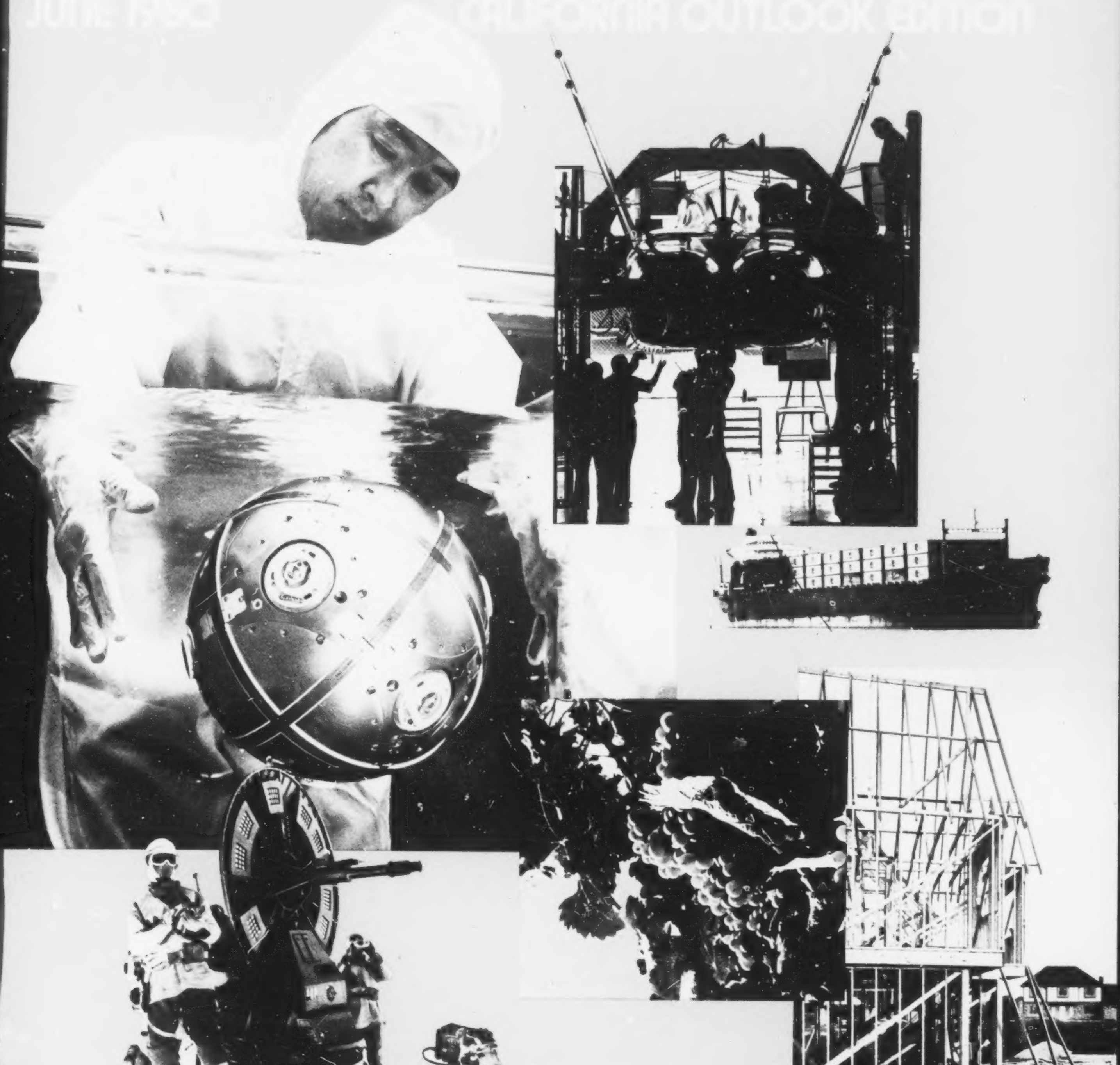
Given that our outlook for California's economy during the next five years is on the whole very favorable, it is also subject to a great deal of uncertainty which could be resolved favorably or unfavorably. There is uncertainty about the continued availability of adequate energy, although this is more a problem of price during the period between now and 1985. More urgent, perhaps, for the southern part of the state is a continued supply of high quality water, since the region's allotment from the Colorado River will be greatly reduced beginning in about 1985. Finally, it is essential that the state's business climate in general should continue to be relatively favorable to economic growth. Given a favorable resolution to these and other uncertainties about resource availability and business climate, it is likely that California's economy will continue to outperform that of the nation during the next five years.

ECONOMIC REPORT

7/1/80 B A50-1 U H-June

JUNE 1980

CALIFORNIA OUTLOOK EDITION



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CALIFORNIA OUTLOOK EDITION

NUMBER 60

This report highlights the outlook for the California economy through 1981. Subsequent issues of the ECONOMIC REPORT will highlight:

1981 U.S. Outlook, September 1980
International Edition, December 1980
Long-Term U.S. Outlook, March 1981

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ECONOMIC REPORT

JUNE 1980

5 Declining employment and real income will be accompanied by weak retail spending during the remainder of 1980 in California. The economic downturn will not be as severe as that expected nationally, and a broadly based recovery will begin in early 1981.

11 Continued gains in aerospace and electronics, agriculture, and international trade will offset weakness elsewhere in the economy. The outlook for construction and banking is also discussed.

22 The inflation problem is examined from both short-term and long run perspectives, with particular emphasis on California price trends.

26 The nation is experiencing a serious recession, but this downturn should temper inflationary pressures. A gradual recovery is expected in 1981.

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Summary

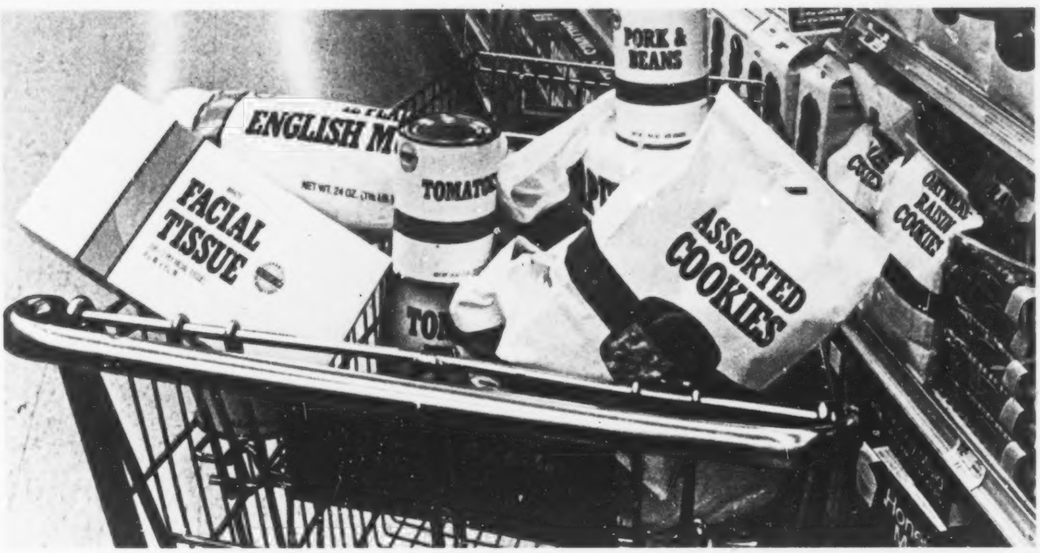
The major theme of this report is the outlook for the California economy through 1981. A detailed analysis of trends in employment, income and retail sales concludes that California will not suffer as sharp a downturn as the national economy during the current recession. However, the trend rate of growth in employment during the next eighteen months will be well below the experience of recent years, and only modest gains in real income will be realized. Net migration to the state is expected to continue to fuel rapid labor force growth, and declining employment opportunities this year will result in a sharp increase in the state's unemployment rate.

The severity of the recession in California should be moderated by the strength of basic sectors including aerospace and electronics, agriculture, and international trade. The greatest weakness will be centered in residential construction and non-aerospace durable goods manufacturing industries related to motor vehicles and building materials. Sales of durable goods, especially motor vehicles, will also be very weak, and the import share of the California auto market may top 50 percent in 1980.

By early 1981, the state's economy is expected to begin a broadly-based economic expansion that will be led by a recovery of the homebuilding industry. Unemployment will trend gradually downward during the year, but will remain above 8 percent at year end. Inflation will remain a serious problem in California, but will moderate during the next eighteen months, approaching an annual rate of 9 percent by late 1981.

The national economy currently appears to be headed into a severe downturn in which the second quarter will see the sharpest decline in real output. The total drop in real output from the recession's peak, now dated in January, 1980, to the projected trough in the year's fourth quarter, is expected to be 3.4 percent, which is milder than the 5.7 percent drop of the 1973-1975 recession. The consumer sector will be hit harder than in the prior cycle, while the 1980 decline in housing will be only slightly less than in the last downturn. By early 1981, moderating inflation and lower interest rates should stimulate a modest pick up in spending, and a very gradual recovery will begin.

The California Near-Term Outlook



OVERVIEW

The prolonged economic expansion of California's economy that began in 1976 now appears to be at an end. The period of 1976-1979 was one of unprecedented employment gains in the state. Nonagricultural employment increased by more than 1.5 million, or 19 percent, during that period, and the job growth was accompanied by similarly impressive gains in personal income, retail spending, and construction activity.

During the period since 1975, California's economy has repeatedly demonstrated its capacity to overcome any obstacle that appeared to present a threat to continued economic expansion. Challenges that were met and, in the opinion of most observers, largely overcome were the "business climate" controversy of 1976; the great drought of 1977; the tax revolt that resulted in the passage of Proposition 13 during 1978; and the real estate crash that has been predicted continuously ever since early 1977, and still shows no sign of occurring in the near future.

Thus far in 1980, in spite of temptations to vote themselves a hefty tax cut by passing Proposition 9 on the June ballot, California voters appear to have acted prudently in defeating a measure that could have been painful for the state to absorb during a period of reduced revenue growth. Additionally, the vote against imposing a higher tax on energy-related enterprises doing business in the state, embodied in ballot Proposition 11, probably avoided a resumption of the whole business climate controversy of 1976.

However, the California economy is currently faced with an obstacle that it cannot entirely avoid—the effects of a serious national recession whose onset has already been dated at January, 1980, by the National Bureau of Economic Research. While California's strength in aerospace/electronics manufacturing, agriculture, international trade, and many of the service industries will prevent the state from experiencing the full severity of the downturn expected nationally, our forecast calls for negative real growth in the state's economy during the second, third, and fourth quarters of 1980. The unemployment rate is expected to approach 9 percent by early 1981, when California should begin to see a moderate but broadly based recovery led by the homebuilding industry.

In our view it is unlikely, and perhaps even undesirable, that the boom of the late 1970s will soon be repeated in California. The tremendous growth of that period led to demand pressures for goods and services such as housing and health care which are at least partly to blame for the higher inflation rate that has recently been experienced in the state. The housing industry, which was plagued by chronic years of overproduction a few years ago, now faces the equally serious problem of acute shortages and high inflation. Those problems, and their implications for the state's business climate, present one of the major challenges for the California economy during the 1980s.

CALIFORNIA EMPLOYMENT OUTLOOK

During 1979, additions to employment in California continued at a very rapid rate. Total nonagricultural workers reported by the employer payroll survey showed a gain of 5.3 percent following 1978's spectacular 7 percent increase. The household employment survey showed a somewhat smaller but nevertheless solid gain of 4 percent in 1979 following a 6.1 percent rise in 1978. The trend rate of growth in the nonfarm payroll employment series during the economic expansion years of 1975-1979 was an impressive 5.4 percent, compared with a trend rate of 4.3 percent for the 40-year period from 1939 to 1979, which includes the explosive employment growth of World War II.

The interim series on nonagricultural employment continued to show a very high rate of employment growth through the first quarter of 1980. The household employment survey, however, was showing a slight decline in the first quarter, and a sharp increase in unemployment during April. It appears possible at this point that the household survey, generally the less reliable of the two, may have understated the extent of employment growth during the first quarter, but has called a definite turn in the economy during the year's second quarter. The turning point in the second quarter is supported by current regional weakness in other sectors, such as department store sales, construction activity, and the automotive sector and supporting industries. These considerations, plus the national outlook for declining real growth through year-end 1980, support a conclusion that the first quarter's employment total was the peak for the year.

Our forecast calls for a decline in employment during the second and third quarters of 1980, with no significant gains being realized until early 1981. It is likely that demographic forces, including continued net migration to California at an annual rate exceeding

CALIFORNIA EMPLOYMENT [illegible]

(Thousands)

				Annual Growth Rates		
	1979A	1980F	1981F	1978-79	1979-80	1980-81
Civilian Labor Force	10,969	11,228	11,572	3.0	2.4	3.1
Total Civilian Employment	10,286	10,384	10,581	4.0	1.0	1.9
Unemployment	683	844	991	−9.7	23.6	17.4
As % of Labor Force	6.2	7.5	8.6			
Nonagricultural Wage & Salary Workers	9,680	9,964	10,158	5.3	2.9	1.9
Mining	39	42	44	6.2	6.4	4.8
Construction	463	453	450	10.9	−2.2	−0.7
Manufacturing	2,002	2,054	2,137	6.8	2.6	4.0
Nondurable Goods	644	645	662	3.2	0.2	2.6
Durable Goods	1,358	1,409	1,475	8.5	3.8	4.7
Aerospace	582	630	668	15.0	8.2	6.0
Transportation & Public Utilities	537	553	554	6.0	3.0	0.2
Trade	2,232	2,305	2,335	5.0	3.3	1.3
Finance, Insurance, & Real Estate	597	614	635	8.0	2.8	3.4
Services	2,081	2,185	2,242	7.7	5.0	2.6
Government	1,729	1,758	1,760	−1.2	1.7	0.1
Federal	321	324	322	0.6	0.9	−0.6
State & Local	1,408	1,434	1,438	−1.6	1.8	0.3

A = Actual F = Forecast

150,000, will keep the state's civilian labor force growing at an annual rate of 2 percent or more through 1981. That continued labor force growth, combined with the expected decline in employment levels, will result in an increased unemployment rate this year. The unemployment rate is projected to increase from the first quarter's low reading of 6 percent to 8.7 percent by the fourth quarter, remaining above 8 percent through 1981. During the recession this year and the slow recovery in 1981, the employment pattern by industry is likely to be very mixed, with some sectors such as aerospace/electronics showing continued rapid gains while others, such as construction, show year-over-year declines. The following comments summarize the sectoral outlook for California employment during 1980 and 1981.

The mineral extraction industries in California now appear to have entered an era of more rapid growth due to the provision of greater price incentives. The general federal government move toward deregulation of crude oil and natural gas prices has benefited exploration and development activity nationwide, and California should derive particular benefit from the deregulation of heavy crude oil, of which the state has large reserves. Employment growth in this sector should average over 5 percent per year through 1981.

Manufacturing industry in California contains areas of both strength and weakness, ranging from the booming aerospace/electronics industries to the depressed motor vehicle and building materials activities. Durable goods manufacturing, which is more than 40 percent aerospace and electronics production, should fare better as an employment source than the nondurable goods manufacturing sector, although the strength of aerospace and electronics production is counterbalanced by weakness in other durable goods industries such as motor vehicles and equipment, lumber and wood products, furniture and fixtures, and stone, clay and glass products. Excluding aerospace/electronics, durable goods manufacturing employment is expected to grow only 0.4 percent in 1980, with a return to a more normal 3.6 percent gain in 1981, as the motor vehicles and building materials industries should revive somewhat by then. Employment in the nondurable goods manufacturing industries is expected to be virtually flat in 1980, recovering to a 2.6 percent growth rate in 1981.

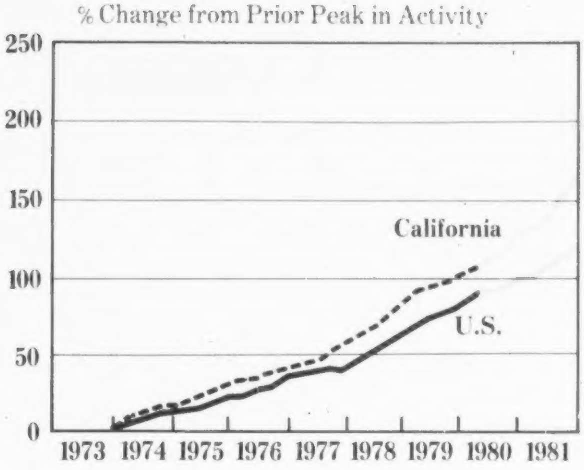
The construction sector will see diminished job opportunities this year, as the effects of tight money and high interest rates discourage both builders and potential homebuyers from entering the market until prospects improve, probably by early 1981. It currently appears, however, that the construction slump will be milder than that of 1974-1975, based on strong demographic demand combined with an apparent housing shortage that should make the recession short-lived. Additionally, nonresidential construction activity will continue at a relatively high level due to the large volume of projects undertaken before the credit squeeze began to affect the volume of new permits for nonresidential projects. In total, average construction employment in California is expected to decline 2.2 percent in 1980 and a further 0.7 percent in 1981, although hiring should actually be on an uptrend through most of 1981.

Employment prospects in the trade and service sectors will be better than average this year, with some weakness in the trade sector likely to be offset by continued gains in service sector employment. Wholesale and retail trade are likely to be feeling the effects of the slowdown in consumer spending, and employment levels may show some decline from the strong first quarter reading. Service employment should see a slowing of growth, particularly during the second half of 1980, but at this point a decline in service employment appears unlikely, since consumer spending for services is expected to continue to grow in real terms throughout 1980 and 1981.

With the defeat of Proposition 9 and the failure of the Tax Simplicity Act to qualify for the November, 1980, ballot, it is likely that state and local government employment will stabilize at or very near current levels. The Gann spending limitation, passed last November as Proposition 4, is now being implemented by the state legislature and should become binding sometime during fiscal year 1981 or 1982, serving to restrain growth in spending as well as employment. Additionally, our forecast for total nonagricultural employment growth for the four quarters of fiscal 1981 is a weak 1.4 percent, much lower than the growth rate for either calendar year 1980 or 1981, which should limit revenue growth sufficiently to exhaust most of the state budgetary surplus. For these reasons, employment gains in state and local government are likely to be very modest. Federal government employment is likely to stabilize at about 322,000 following completion of the federal 1980 Census of Population later this year.

PERSONAL INCOME AND ITS COMPOSITION

California personal income increased an impressive 14.2 percent during 1979, surpassing even the 13.9 percent gain of 1978, when real income grew more than 6 percent. The real income gain during 1979 was of more moderate size, an estimated 3.7 percent, using the Los Angeles area Consumer Price Index (CPI) as a deflator. By comparison, the national gains in current dollar and real personal income during 1979 were, respec-



tively, 12 percent and 0.7 percent. Real personal income per capita in California increased to almost $4700 during 1979, compared with about $4000 nationally.

We currently project that California personal income will grow an additional 12.7 percent in 1980, attaining a total of over $256 billion for the year. Using the expected rate of consumer price inflation for 1980 as a deflator would provide for a decline of over 3.2 percent in real income, which is likely to overstate the loss given some of the measurement problems involved in the CPI, discussed later in this report. If one were to use, instead of the CPI, an estimate of the deflator for personal consumption expenditures, analogous to that computed quarterly for the nation, the real income decline would be only a slight 0.1 percent. The personal consumption deflator thus derived would produce a 1980 inflation rate of 12.8 percent, rather than the 16.5 percent rise projected for the Los Angeles CPI.

1981 should see a return to stronger income growth, resulting in a gain of 13 percent in current dollars and 2 percent in real terms, assuming a price increase of 10.5 percent, as measured by both the CPI and PCE deflator concepts. The combined 1980-1981 increase of about 2 percent in real personal income in California implies a decline in real personal income per capita, since the state's total population is currently increasing at an annual rate of about 1.7 percent, or 3.4 percent for a 2-year period.

The largest percentage increase shown by any component of California personal income during 1979 was that of "other labor income," a relatively small category that consists of fringe benefits, employer contributions to pensions, reserve pay, and other minor income sources. Other labor income in California increased 21.2 percent last year, following a gain of 18.8 percent in 1978. Growth of this income source is expected to slow to about 14 percent this year and about 17 percent in 1981.

Wages and salaries, which comprise the largest component of personal income, grew at a slightly lower rate than total personal income last year, and consequently, accounted for a slightly lower proportion of the California total. The faster overall growth of non-labor sources of personal income which began last year is expected to continue through 1981, with wage and salary income increasing at annual rates of about 12.5 percent in 1980 and 12 percent in 1981.

Property income, consisting of dividend, interest, and rental income, appears likely to be the most rapidly growing income source during 1980, with an expected growth rate of close to 20 percent this year. In 1981, a further gain of 15 percent is anticipated. To a great extent, the current surge in property income refects the high average levels of interest rates during 1980. It is likely that rent controls, now widespread in California, will dampen the increase in rental incomes to some extent, causing rental income to decline substantially as a share of the property income total during 1980 and 1981.

Transfer payments in California are expected to rise sharply in 1980 due to the economic slowdown. Transfer income, which is very cyclical in nature, reached a peak 14.5 percent of total personal income in the state during the recession year of 1975. That percentage had declined to about 12.3 by 1979 as a result of the boom in employment growth following the last recession. In 1980, transfer income is expected to grow more than 15 percent as unemployment increases sharply, with a further rise of 14 percent in 1981, when unemployment levels are expected to remain relatively high in California.

RETAIL SALES

After leading the state's economy out of the economic slump of 1973-1975, the consumer sector in California recorded four years of very strong growth. Total retail sales in the state expanded at a compound annual rate of 12.8 percent from 1975 to 1979. Durable goods sales increased an average 19 percent per year over that interval, and sales of nondurable goods increased only about half as fast, or 10 percent per year.

Total retail sales increased 15.6 percent in California during 1979, outpacing the growth in personal income by a modest margin. Sales of durable goods continued to surge, recording an increase of 18.7 percent, although most of the increase came during the

INCOME, PRICES AND RETAIL SALES, 1979-1981

	1979A	1980F	1981F	Annual Growth Rates 1978-79	1979-80	1980-81
Income & Spending ($ bil.)						
Personal Income	227.4	256.3	289.6	14.2	12.7	13.0
Retail Sales	99.9	108.9	120.7	15.6	9.0	10.8
Durable Goods	35.6	36.7	39.7	18.7	3.1	8.2
Nondurable Goods	64.2	72.2	81.0	13.6	12.5	12.2
Prices (1967=100)						
Los Angeles Consumer Price Index	213.7	249.0	275.2	10.8	16.5	10.5

A=Actual F=Forecast

first half. The durable goods gain was led by sales of building materials and home appliances. Motor vehicle sales increased nominally, although price increases, rather than higher volume, appeared to account for most of the gain. California also experienced a boom in sales of "other" durables, the so-called collectible category consisting of precious metals, stamps and coins, jewelry, antiques, and similar merchandise. Fear of renewed inflation stimulated much of the expansion in sales of collectible goods.

Unit auto sales suffered in California, as nationally, from higher operating costs, increased prices, and a shortage of domestically produced small cars. The net result of these factors was a 6 percent decline in unit auto sales in California, from 1978's 1.11 million units to about 1.05 million in 1979. Additionally, sales of domestically made autos declined almost 15 percent, to 602,000 units, while sales of imported cars gained over 9 percent, to 443,000 units. During the fourth quarter of 1979, the import market share in California attained an apparent all-time record at 47.4 percent, up from a low reading of 34 5 percent during the year's first quarter, preceding the gasoline shortage that began during May.

The outlook for durable goods sales in 1980 calls for continued weakness in the automotive sector, with a further decline from last year's sales volume and an import share that is likely to exceed 50 percent. Total 1980 durable goods sales are expected to gain only 3.1 percent in current dollars, which would nevertheless be a better performance than the 1 percent decline in 1974, during the last recession. The recovery, however, is expected to be relatively weak in 1981, with a projected growth rate of 8.2 percent for durable goods.

INCOME, PRICES & RETAIL SALES

Quarterly Detail, 1980-1981

	1980F I	II	III	IV	1981F I	II	III	IV
Income & Spending ($ bil., SAAR)								
Personal Income	245.7	252.2	259.8	267.5	276.2	284.9	294.8	302.5
Retail Sales	107.7	107.2	108.9	111.8	115.7	119.1	122.4	125.7
Durable Goods	38.2	35.8	35.9	36.9	38.2	39.2	40.2	41.2
Nondurable Goods	69.5	71.4	73.0	74.9	77.5	79.9	82.2	84.5
Prices (1967=100)								
Los Angeles Consumer Price Index	237.2	246.2	253.2	259.3	265.8	272.1	278.3	284.4
Percent Change	24.2	16.1	11.9	10.0	10.4	9.8	9.4	9.1

SAAR=Seasonally Adjusted Annual Rates F=Forecast

The 1981 outlook for durables, in California as nationally, is conditioned by continued sluggish auto sales, with total volume increasing less than 10 percent from 1980's weak volume.

Nondurable goods sales have continued to show a slower but steadier growth path than durable goods. Last year's gain in retail sales of nondurable goods was a respectable 13.6 percent, about the same as the increase in personal income. 1980 sales of nondurables are expected to increase 12.5 percent, followed by a further gain of 12.2 percent in 1981. These growth rates, which incorporate a sizable inflation factor, are somewhat above the average 10 percent growth rate of nondurable goods sales during the 1975-1979 period, but not unlike the experience of 1974-1975, when nondurable goods sales in California maintained average growth rates of almost 12 percent per year.

It may be interesting to highlight some of the state's recent sales trends in terms of more detailed product categories. By far the fastest growing category in 1979 was the service station group, where the pass-through of the OPEC crude oil price increase resulted in a 34.5 percent increase in current dollar sales. Total volume of gasoline sold actually declined in California last year, as did the number of service stations. The building materials and farm implements category experienced an 18.4 percent increase in 1979 sales, with plumbing and electrical supplies increasing 34.5 percent, in part due to the continuing strength of the home improvement market. Lumber and building materials showed an increase of 16.6 percent.

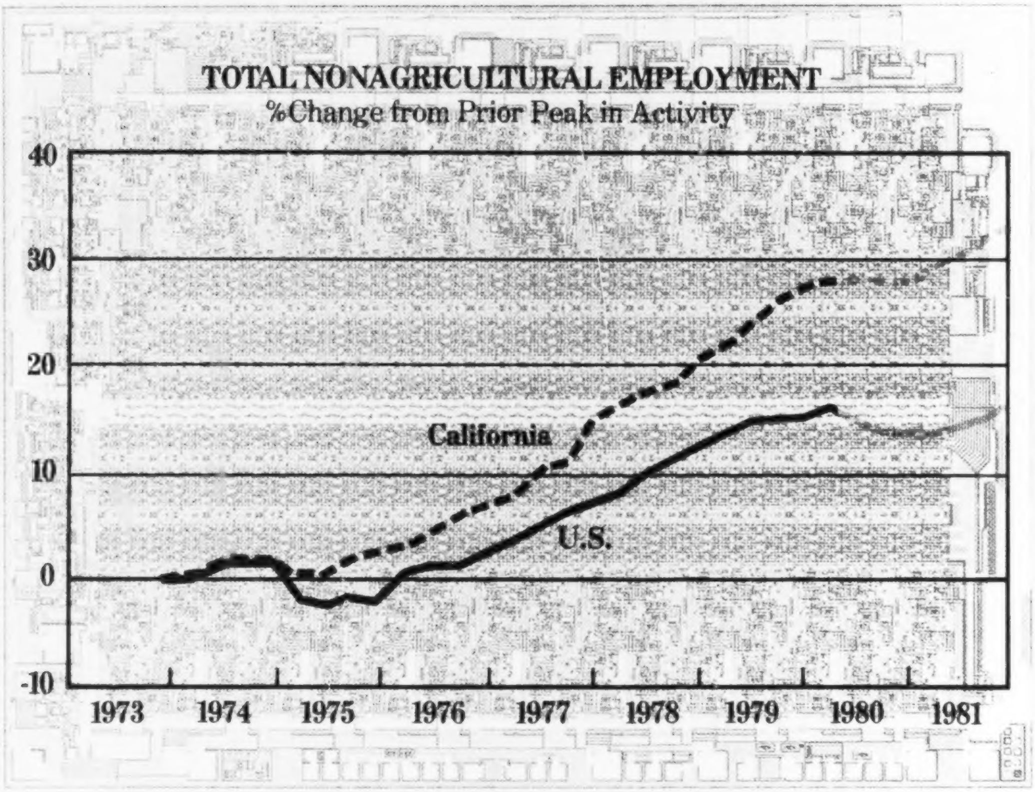
Detailed sales results from motor vehicle and parts dealers show a very uneven pattern, with the greatest weakness in auto and mobile home sales. The category of mobile homes, trailers, and campers showed a sharp decline of 7.7 percent, undoubtedly in response to more expensive and tighter supplies of fuel. New motor vehicle dealers managed a meagre increase of only 2.5 percent, while used motor vehicle dealers fared slightly better with a 7.1 percent gain. For the first time in history, dollar sales of service stations exceeded those of new motor vehicle dealers, $12.2 billion to $12.0 billion. Automotive supplies and parts stores showed a 14.7 percent gain, and the category of boat, motorcycle, and plane dealers had a sales increase of 20.7 percent.

Quarterly Detail, 1980-1981
(Thousands, Seasonally Adjusted)

	1980F				1981F			
	I	II	III	IV	I	II	III	IV
Civilian Labor Force	11,063	11,200	11,283	11,367	11,465	11,536	11,607	11,679
Total Civilian Employment	10,404	10,389	10,361	10,380	10,452	10,530	10,620	10,721
Unemployment	659	811	922	987	1,013	1,006	987	958
As % of Labor Force	6.0	7.2	8.2	8.7	8.8	8.7	8.5	8.2
Nonagricultural Wage & Salary Workers	9,985	9,970	9,943	9,959	10,031	10,108	10,196	10,296
Mining	41	41	42	42	43	43	44	44
Construction	473	460	442	437	442	447	453	460
Manufacturing	2,045	2,054	2,055	2,062	2,090	2,125	2,153	2,180
Nondurable Goods	648	646	643	643	650	660	667	672
Durable Goods	1,397	1,408	1,412	1,419	1,440	1,465	1,486	1,508
Aerospace	614	626	636	644	652	662	674	686
Transportation & Public Utilities	559	554	550	549	550	552	555	560
Trade	2,315	2,307	2,299	2,300	2,315	2,325	2,340	2,360
Finance, Insurance & Real Estate	621	612	610	614	621	629	639	650
Services	2,169	2,180	2,190	2,200	2,215	2,235	2,250	2,270
Government	1,762	1,762	1,755	1,755	1,755	1,752	1,762	1,772
Federal	327	327	322	322	322	322	322	322
State & Local	1,435	1,435	1,433	1,433	1,433	1,430	1,440	1,450

F = Forecast

California Industry Trends



Background shows a high speed memory circuit enlarged approx. 55 times.

AEROSPACE INDUSTRY TRENDS

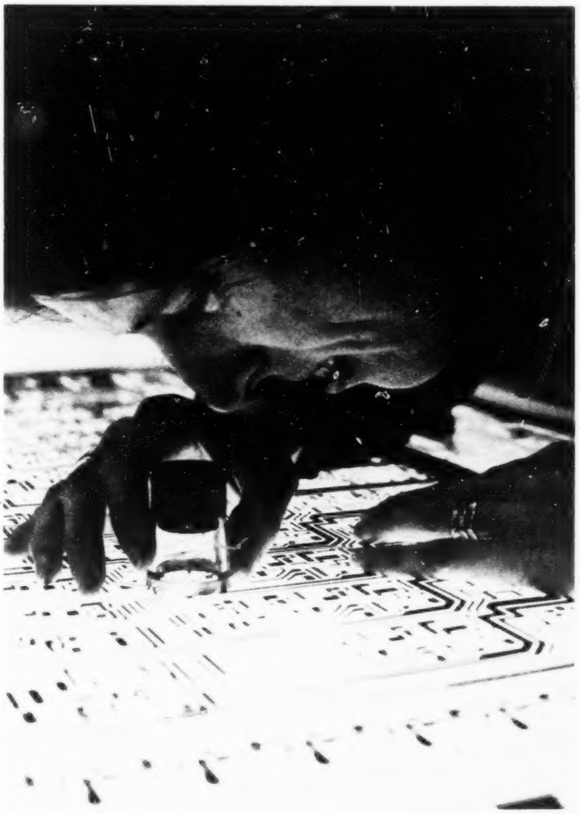
During 1979, California's aerospace manufacturing sector continued to increase its share of total manufacturing industry in the state, and continued to account for a disproportionate share of national aerospace production. In total, the aircraft, electronics, and related industries accounted for a combined payroll of over 582,000 workers during 1979, up 15 percent from the 1978 total. Prime Department of Defense contract awards for the first three quarters of 1979 were also up about 15 percent from year-earlier levels, and virtually all segments of the industry were growing at rates that were historically very high. By March of 1980, total aerospace employment had attained a seasonally adjusted total of over 617,000, exceeding the prior employment peak of about 612,000 attained during 1967, when the industry was defined somewhat differently for purposes of payroll reporting. That previous peak level of employment corresponded closely to the peak level of defense production during the period of the nation's military involvement in Southeast Asia. The decline from that 1967 peak was precipitous. By mid-1971, less than four years later, total employment in the state's aerospace sector had declined to only 435,000, a loss of more than 175,000 jobs from the peak employment level of 1967.

In the present situation, not only does the current record employment total not represent another cyclical peak, there appears to be no prospect for a decline for at least the next few years. Defense procurement in real terms has only recently begun to grow again after declining steadily throughout most of the decade of the 1970s. Further, the President's budget message for fiscal year 1981 gave a hint of further sizable increases in real defense spending in the years immediately ahead. While the potential magnitude of the additional defense spending during the next several years appears to have been exaggerated in many popular interpretations of the Presidential message, the shift in direction from the trend of the recent past was clear. We definitely appear to be headed into an era of increased international tensions in which the overwhelming policy choice has been the adoption of a policy of greater military preparedness, particularly in the area of conventional warfare armaments and "general purpose" armed forces.

The prospect of an increasingly hostile world in which California's defense producers end up as winners is one which may give little comfort to a large portion of the public. We should point out that, even with the anticipated increases in defense spending during the next few years, it is likely that California's aerospace sector will be far less dependent on military business than during the boom of the 1960s, which quickly turned to a massive bust, with dire implications for unemployment, retail sales, and real estate. During the current boom, the industry is much more diversified among defense, commercial, and household goods. During 1978, for example, total defense prime contract awards in California, in constant 1972 dollars, were almost 22 percent less than during the peak year of 1967, and there is some doubt that even 1980's volume will surpass the 1967 real level. The major difference in the current cycle is in the higher share of aerospace production for non-military end-use, which makes use of sophisticated technology developed during the course of Defense- and NASA- sponsored research and development activity.

While the overall growth of aerospace manufacturing the past two years has been impressive, the growth of most of the seven component industries that are included in the aerospace total has been equally remarkable. The leading aerospace industry in terms of both total employment and growth rate during 1979 was the aircraft and parts industry, with an employment total of 141,300 representing a 20.3 percent increase for the year. Both military and commercial aircraft production enjoy favorable prospects for the next several years. While commercial aircraft sales might normally be expected to exhibit some cyclical weakness as passenger loads decline, as they did during the previous recession, the circumstances of the air line companies are quite different during this cycle. First, the passenger loads are holding up very well so far in this economic cycle. Due to the relatively weak value of the U.S. dollar in terms of most other hard currencies, travel to the United States continues to be a bargain for overseas visitors. It was recently reported that, for the first time in history, over half of all passengers arriving or departing on international flights in the United States were non-U.S. citizens. Additionally, the deregulation of air fares on domestic flights has led to increased competition with numerous bargain fare arrangements to attract new passengers. Other forces that argue for the rapid replacement of older aircraft are the economic incentive to reduce operating costs through improved fuel economy as well as regulatory pressure to reduce aircraft noise.

The electronic components and accessories industry, with an average employment level of 113,300 in 1979, was the second most rapidly growing industry in the aerospace group last year with a gain of 16.4 percent. Employment in this industry has risen over 50 percent since 1976, reflecting the multitude of new uses now being found for high-technology electronic components in military, commercial, and household applications.



Office and computing machinery, which accounted for a total employment of about 93,000 workers in 1979, grew more than 16 percent last year and almost 50 percent in the past three years. This is another industry with basically good prospects for the next several years, with the possibility of a cyclical slowdown during the current recession. Communication equipment, which consists mainly of telephone and telegraph apparatus plus radio and television transmitting equipment, is the second largest employer in the aerospace group with 123,400 employees in 1979, when the industry's job totals grew 9 percent, and could continue at or near that growth rate during 1980 and 1981. The industry showed unusual countercyclical strength during the 1974-1975 period.

Three smaller industries collectively accounted for somewhat less than 20 percent of aerospace employment last year. These are measuring and controlling devices, with 41,800 employees and an 11.9 percent growth rate in 1979; guided missiles, with 51,500 workers and an 8.1 percent increase; and radio and television receiving equipment, with 18,100 employees and a relatively weak 1.6 percent growth rate.

CALIFORNIA AGRICULTURAL OUTLOOK

1979 was a record year for both gross and net earnings in California's important farm sector, giving farmers increased cash reserves that will be needed to weather the increased cost pressures on net farm earnings during 1980 and 1981. Total cash receipts from farming amounted to almost $11.8 billion in 1979, up 13.5 percent from the 1978 total of $10.4 billion. Preliminary estimates of 1979 net farm income range as high as $3.8 billion, which would be a gain of almost 23 percent from 1978's revised total of $3.1 billion.

Cash receipts from livestock increased a very strong 15.8 percent, to a total of almost $4 billion, in 1979. Total gross income from cattle and calves benefited from strong price trends during the year, attaining a total of $1.8 billion which was up more than 30 percent from the 1978 figure. Herd sizes, however, continued to decline through 1979 and have not yet bottomed out, with the rebuilding phase now expected to be delayed until late 1980 as a result of the unwillingness of ranchers to undertake increases in herd sizes at the beginning of a recession. The diminished quantity of beef going to market last year led to a considerable increase in production of hogs and chickens, and those meat sources are now being pared down as a result of overproduction and weakening price trends.

The dollar volume of crop marketings in California was up 12.4 percent to $7.8 billion in 1979 as a result of abundant water, relatively good growing conditions, and strong demand for most crops. The cotton crop was a star performer in 1979 with total cash sales of $1.3 billion, up almost 90 percent from the relatively depressed production of 1978. Cotton sales are continuing to benefit from relatively strong export demand and the reduced competition from synthetic fibers, which have soared in price along with the cost of the primary input, petroleum. The hay crop was another major revenue producer in 1972 with total sales of $616 million, a gain of almost 50 percent over 1978's total.

Fruit and nut crops, led by grapes and almonds, had a relatively good year in 1979. The grape crop had a total of about $1 billion, for an increase of about 15 percent from 1978's total. Both table grapes and wine grapes experienced strong increases in production. There is some concern, however, that growers may have over-emphasized production for red wines, which have not won over consumer palates from white wines as rapidly as was anticipated by the industry, thus leading to some imbalance in vineyards. Grafting and replanting has lessened the problem in the short term. The almond crop, enjoying good export demand, more than doubled in value to $559 million in 1979. Production of pistachios continued to increase, although most acreage, aimed at future production, is presently non-bearing.

Cash receipts from processing tomatoes increased

27 percent to $429 million last year, leading to excess inventories of processed tomatoes and resulting in a 15 percent reduction in acreage contracted by canners. There is concern that smaller operators may be unable to compete with larger operators with lower production costs during a period of excess stocks. The lettuce crop, which is more speculative in nature than some other vegetables, was an exception to the general pattern of increasing sales last year, showing a decline of almost 20 percent from 1978 sales, with total receipts of $369 million.

Rounding out the picture, sales of nursery products increased more than 21 percent to $435 million last year. Egg production was up only modestly, to $347 million, as egg prices remained at relatively low levels. Sales of milk and dairy products increased about 14 percent to $1.4 billion, slightly surpassing cotton as the second most important cash crop, behind cattle and calves.

While the outlook for farm production is on the whole favorable for 1980 and beyond, the industry is likely to see reduced earning margins this year as a result of increased cost pressures. Net farm income is likely to decline as much as 10 percent due to increased costs of energy, water (primarily pumping costs), labor, and financing. While these factors were also the source of increased operating costs last year, 1979 was a year of strong revenue growth and money was relatively available for short-term financing needs. In 1980, total farm production cost is projected to increase 21 percent, with operating costs climbing 27 percent and the cost of materials gaining 8 percent. Much of the increase in operating costs is energy-related.

Another factor that has recently begun to concern California agricultural interests is the rapidly rising cost of farmland. California agricultural real estate is estimated to have increased 23 percent in price during 1979, and a doubling during the next decade is likely. To the extent that this inflation in land values is speculative and unrelated to the value of the land in farm production, it could pose a future problem to the farm sector.

The long-term water supply situation is another potential cloud on the horizon for the California farm sector during the next few years. Long-term concerns for agriculture, industrial and household use following the completion of the Central Arizona Project in 1985, and the attendant reduction in California's Colorado River entitlement. Lesser problems involve environmental concerns that could impede Southern California's continued access to Owens Valley ground water. The projected shortage is a result of past decisions not to build the State Water Project and the Central Valley Project to their originally planned capacity. The Delta Transfer Facility, commonly known as the "Peripheral Canal," is currently the major candidate to replace the Colorado River source.

Finally, the current California pesticide regulations could make the state's agriculture less competitive in future years if something is not done to resolve the difference between the state's tough statutes and the less rigorous federal Environmental Protection Agency (EPA) rules. The same argument would apply to differences between the EPA rules and the standards of other nations which compete with the U.S., especially our neighbors to the south.

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1979 saw the continuation of the strong asset growth at California banks that began during 1976, following the end of the last recession. Total gross loans at California commercial banks increased at a compound annual rate of 18.3 percent during the three-year period of 1976-1979, and last year's gain of 19.6 percent was exceeded by only the boom years of 1973 and 1978 during the decade just ended. 1979 was a year of relatively modest deposit growth, although the growth rates tend to obscure the underlying change that saw explosive growth of the six-month money market certificate (MMC) accounts and interest-bearing demand deposit, or automatic transfer service (ATS) accounts, while traditional savings deposit categories saw disintermediation.

Real estate loans were again by far the fastest growing major asset during 1979, showing a gain of 28.4 percent following the almost 30 percent increase in 1978. Somewhat surprisingly, Federal Reserve data show an acceleration of real estate loan growth during the first four months of 1980, when total seasonally adjusted real estate loans grew 9.5 percent, equivalent to a 31.4 percent annual rate. It is believed, however, that this borrowing in spite of very high mortgage rates reflected a widespread concern that money might cease to be readily available. The high inflation of the first quarter also appears to have lessened buyer resistance to the record high mortgage rates, which peaked above 18 percent at many California lenders. While lending for the purchase of new properties will inevitably slow with the pace of construction this year, the current moderation of mortgage rates should stimulate activity in the resale market. Total real estate lending is expected to show an increase of about 22 percent in 1980, with most of that growth based in the first half. 1981 should see a more modest gain of about 11 percent, with the low level of housing starts in 1980 resulting in fewer completions in 1981.

	1979A	1980F	1981F	Annual Growth Rates 1978-79	1979-80	1980-81
Gross Loans* ($ bil.)	93.27	106.05	114.45	19.6	13.7	7.9
Commercial & Industrial	26.89	29.59	32.06	15.3	10.0	8.3
Real Estate	35.14	42.82	47.47	28.4	21.9	10.9
All Other	31.24	33.64	34.92	14.6	7.7	3.8
Total Deposits	110.27	118.58	129.74	7.7	7.5	9.4
Demand	38.33	40.84	44.41	7.9	6.5	8.7
Time & Savings	71.94	77.73	85.32	7.6	8.0	9.8
Loan-to-Deposit Ratio (%)	84.6	89.4	88.2			

*Minus loans to domestic commercial banks A=Actual F=Forecast

Business lending in California has begun to show the effects of recession, and the prospect is for relatively slow growth in business loans throughout 1981. The 15.3 percent average growth rates shown by business loans at California banks during 1979 reflected broad strength in both major corporate and middle-market lending, even with prime rate increases of over 350 basis points during the year. Loan growth appears to be on a lower growth path thus far in 1980, with smaller companies having been particularly hard hit by the high interest rate trend that saw the prime rate reach a record 20 percent during April. Loan demand should remain somewhat stronger in California than nationally, as the recession is expected to be somewhat milder here. Total business loans at California banks are expected to increase 10 percent in 1980 with a further gain of 8.3 percent projected for 1981, with an annual rate of growth approaching 11 percent during the second half of 1981.

The category of other loans, which consists mainly of consumer-related borrowing, slowed to a growth rate of 14.6 percent in 1979 following the 18.8 percent gain of 1978. During 1980's first quarter, this category grew at an annual rate of only 5.4 percent, and very little additional growth is expected this year, as the consumer sector is expected to bear the main burden of the recessionary decline. Last year's consumer spending surge, which received a boost from inflationary expectations, now appears to have given way to a mood of pessimism and restraint in borrowing, augmented by the real and psychological effects of the Federal Reserve Board's Credit Restraint Program. Consumers appear to have been more than willing to support the objectives of the program, causing some Administration concern over the extent of the curtailment in consumer spending, particularly credit card usage. For 1980 as a whole, the consumer spending slow down is expected to result in a 7.7 percent increase in other loans, with a meagre 3.8 percent rise predicted for 1981, with the year-over-year comparison being distorted somewhat by the flat second half of 1980.

Changes in the liability structure of the California banking industry continued to be dominated by the upward trend in short-term interest rates during 1979. Depositors continued to deemphasize traditional savings categories in favor of interest-sensitive money market certificate (MMC) accounts at banks and savings and loan associations, as well as direct purchase of U.S. Treasury bills or shares in private money market funds. The net effect of this shift of funds into interest-sensitive categories was a rather disappointing 1979 growth rate of 7.6 percent for total time and savings deposits, including large certificates of deposit.

Thus far in 1980, the moderation in money market interest rates that began during April has appeared to slow the flow of money into the more interest-sensitive categories, and it is likely that balances in traditional passbook and other personal savings accounts will begin growing again this year, with an 8 percent increase in total time and savings deposits projected for the year. The recent enactment of a landmark piece of financial legislation, known as the "Depository Institutions Deregulation and Monetary Control Act of 1980," will have important ramifications for the structure of commercial bank liabilities in 1981 and beyond. Among other provisions, the legislation authorizes the gradual phasing out of Regulation Q interest rate ceilings; permanently authorizes automatic transfer services; and gives nationwide authority for NOW (Negotiable Order of Withdrawal) accounts for all banks, effective December 31, 1980.

Given the competitive nature of the California depository market, it is likely that NOW accounts will become very widespread at the state's banks and savings and loan associations next year.

The widespread issuance of NOW accounts that is expected during the next several years will further obscure the distinction between savings and demand deposits that became clouded with the advent of automatic transfer accounts in 1978. Our forecast for demand deposits, therefore, does not attempt to distinguish interest-bearing from non-interest bearing categories, but addresses the total transaction balance of whatever kind consistent with other economic trends. On that basis, total demand deposit balances, which gained 7.9 percent last year, are expected to show a slower growth rate of 6.5 percent in the recession year of 1980, recovering to show a rise of 8.7 percent during 1981. It should be noted that the 1981 forecast would be conservative to the extent that NOW accounts served as a source of savings as well as transaction funds.

CALIFORNIA'S INTERNATIONAL TRADE: 1979

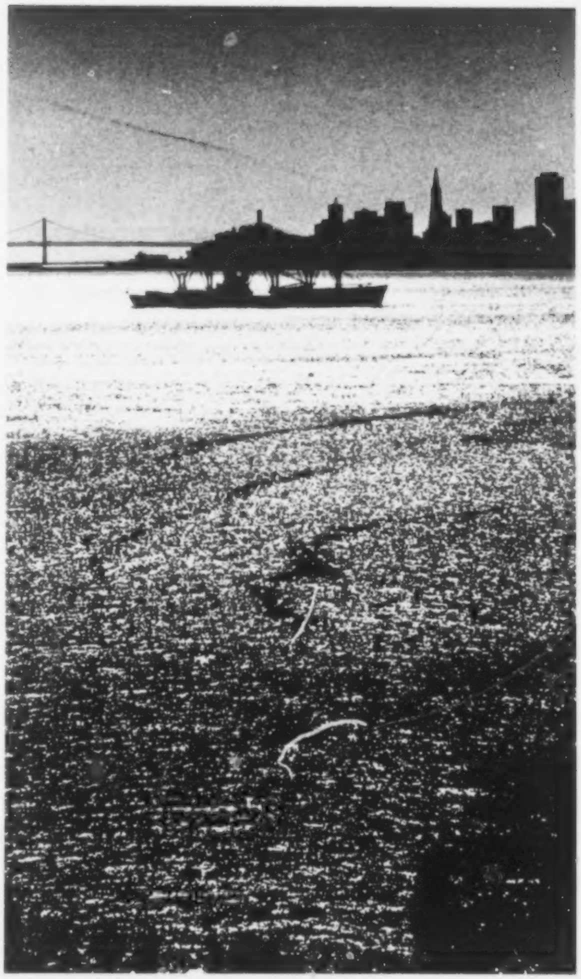
Overview

California's international trade performance during 1979 was outstanding. Led by an unprecedented 37 percent leap in the value of exports,* the state's total trade value increased by 21 percent over 1978. A relatively modest increase in the value of imports—16 percent over 1978—combined with the export surge to cut the state's trade deficit by 30 percent. The deficit decrease in 1979 contrasts sharply with the spiralling increases experienced in the previous years.

The state's three customs districts—Los Angeles, San Francisco and San Diego—handled a volume of goods valued at $45.2 billion in 1979, placing the state in third position nationally after the states of New York and Texas.

Exports

The star of California's 1979 performance was exports. Exports were expected to show strong growth in 1979, increasing in value by 20-25 percent over 1978. In actual fact, the value of merchandise exports moving through the state's customs districts increased by 36.6 percent from $14.9 billion in 1978 to $20.3 billion in 1979. The unusually high increase can be attributed to several factors: the economic performance of some of the state's major trading partners such as Japan, Taiwan, and South Korea, the much delayed effect of the decline in the value of the U.S. dollar, and the heightened demand for certain products traditionally exported through California's ports such as aircraft & parts, high technology items, and agricultural products.



The most important categories of products exported during 1979 were machinery and mechanical equipment, electrical machinery and equipment, and transportation equipment. Although transportation equipment was third in terms of dollar value it was first in terms of year-over-year percentage increase—a remarkable 50 percent. Aircraft and parts represented 67 percent of the category. The increase registered by this category not only points to the strength of sales worldwide of American-built aircraft but also creates future export demand in the form of parts to service the airplanes.

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*It is important to note that the value of the goods exported and imported cannot be totally ascribed to California's economy, as the U.S. government records only the movements of commodities through the various ports and airports, not the points of origin or ultimate destinations.

Since the state's potential growth in exports is dependent upon its trading partners' domestic economies, the outlook for California's exports in 1980 is not quite as bright as the 1979 performance. The industrialized nations of the world are all expected to experience lower levels of real economic growth accompanied by decreases in their import demand. In turn, the less developed nations' economies will be hard hit because the industrialized nations have been, traditionally, their major export markets. The shrinking of those exports markets combined with high oil prices will seriously affect the ability of less developed nations to pursue their development programs thus implying lower growth for California exports. However, prospects remain fairly good for certain components of exports such as airplanes & parts, agricultural products, and electronic components.

Exports through California's ports are expected to grow at an 18 percent pace during 1980. However, the first two quarters of the year will probably be much stronger than the average would indicate reflecting the strength of the state's trading partners during the latter part of 1979.

Imports

Restraint was the hallmark of California's import performance in 1979. Restraint on the part of the state's suppliers and restraint on the part of the consumer. The $24.9 billion worth of goods imported through the state's customs districts in 1979 represented a 15.8 percent increase in value over 1978. Price factors accounted for most of that increase, and real growth was minimal or negative for some categories of products.

Transportation equipment imports remained the largest category in dollar-value terms—$4.6 billion in 1979 —an increase of 17.8 percent over the 1978 total. The 1980 outlook for cars—the most important component of the category with a 61 percent share—is uncertain. The U.S. government has stated repeatedly that no import sanctions will be imposed on Japan, the state's most important supplier of imported cars. However, the industry and unions have been very vocal in their demands for either import restrictions or to have the Japanese manufacture cars in the U.S. The dispute is certain to be exacerbated as the recession makes itself felt in the U.S.

The pattern of electrical machinery and equipment imports showed dramatic changes during 1979. Although the category as a whole registered a 14 percent increase over 1978's total, consumer electronic products such as TVs, radios, and tape recorders which comprise 41 percent of the category, registered a decline from 1978's levels. Further declines of these types of products are expected for 1980, as inflation and high credit costs erode personal income and cause cutbacks in consumer spending.

Petroleum imports also registered a year-over-year decline in volume although the value increased 15.3 percent from the 1978 level to reach $2.6 billion in 1979. The modest increase registered in the total value of imported petroleum contrasts sharply with the average 46 percent rise in the OPEC oil prices during the same period. Decreased consumption and the availability of Alaskan oil were responsible for diminishing the impact of skyrocketing OPEC oil prices.

Imports of machinery and mechanical equipment and metals and their alloys followed with a value of $2.3 and $1.3 billion respectively.

The current year should match 1979's performance as far as California's imports are concerned. The total value of the state's imports is expected to go up by approximately 15 percent, mostly due to price increases. Consumer items are expected to be hardest hit by the impending recession thus offsetting some of the price increases by reduced volume.

An important exception to the overall pattern will be petroleum imports. The over 100 percent increase in OPEC prices between the first quarter of 1979 and the first quarter of 1980 will accelerate the growth of the dollar value of imports during the first half of the year.

Leading Trading Partners

Due to its geographical location, California has traditionally found its major trading partners among the Asian nations bordering the Pacific. The vigorous growth experienced by some of those countries during the past decade has reinforced the geographical ties. As nations such as Japan, Taiwan, South Korea, and Singapore successfully pursued their industrial development goals, they were in a position to buy from the state many of the raw materials and equipment necessary to produce the commodities which, in turn, they sold to California. Japan stands out as the giant among those Asian nations, and its status is reflected in the magnitude of its trade in California. Taiwan, Singapore, and South Korea stand poised at the threshold of the eighties to emulate Japan's performance during the seventies. Other Asian countries such as Malaysia stand ready to take up the position South Korea, Singapore, and Taiwan vacate as they become more fully industrialized. The continued growth and industrialization of the countries mentioned are the key to the continued increase in the volume of trade between the state and Asia. All indications point to the eighties as a decade of continuing growth although the price of oil remains a key prob-

lem threatening further growth. Almost all Asian nations are dependent on imported oil to a significant extent and continued OPEC oil price hikes of the magnitude experienced in 1979 would seriously hamper the development of many Asian nations and, eventually, the growth of trade. (The average OPEC price in 1979 was 46 percent over that for 1978. SPNB forecast calls for a 58 percent rise in the average price of oil in 1980 and a substantially smaller 11 percent increase in 1981.)

In the short term, trade growth is likely to be threatened by protectionist pressures. As economic conditions weaken around the world, the hardest hit industries are certain to demand protection from imports into their own countries and, if this strategy is successful in one country, a round of retaliatory restrictions by that country's trading partners could result. An illustration of this type of sentiment is provided by the current demands for protection being made on the U.S. government by the steel and car industries.

The state's leading trading partners were the same as in 1978. Japan led, followed by South Korea, Taiwan, West Germany and Indonesia. However, only $100 million in total trade separate South Korea and Taiwan, and the latter's growth rates for both imports and exports are higher than South Korea's. If this trend continues during 1980, Taiwan could very well be in second position in 1980 instead of South Korea.

Hong Kong, for the first time, does not appear in the list of the state's top five leading trading partners as it was replaced by West Germany. Indonesia slipped to fifth place as the result of the slower oil import volume.

RESIDENTIAL CONSTRUCTION OUTLOOK

New residential construction in California, as measured by building permits, declined for the second straight year to about 210,000 units, compared with total production of 243,700 units during 1978. 1977 was the peak year of the current housing cycle with a total of 270,600 housing units authorized. The rate of housing production in California, measured by seasonally adjusted quarterly data, did not deviate substantially from an annual rate of 200,000 from the third quarter of 1978 through the fourth quarter of 1979. Clearly, the concern regarding the possibility of speculative overbuilding that surfaced prominently during 1977 and continued through 1978 should now have been virtually put to rest. There is compelling reason to believe that California is facing an increasingly acute shortage of housing, with renewed inflation a distinct possibility in view of the continued under-production that we are forecasting for 1980 and 1981. This year is likely to see only 140,000 units authorized by building permits in California, which would be the lowest total since the 131,700 units authorized during 1975. Some observers estimate the annual replacement requirement for California's housing stock at 1.5 to 2 percent, which would imply perhaps 150,000 units annually simply to keep the stock at a constant 8.6 million units. Given that net migration is now averaging close to 200,000 persons per year, with natural increase in the population adding another 190,000 or so, and a total potential housing demand of at least 250,000 units per year is indicated. It currently appears that the likelihood of producing that much housing annually, particularly at prices that first-time buyers can afford to pay, is not very good until 1982 at the earliest. Thus it is likely that the housing market in California will remain very tight at least through 1981, and that prices will continue upward, although probably at a lower rate of increase than has prevailed during the last few years. Following a rather poor housing year in 1980, the construction industry should approach a more normal production level of 210,000 units during 1981, and should begin catching up with demand by 1982.

The Single-Family Sector

Some 120,000 or more than 60 percent, of all housing authorized in California during 1979 consisted of single-family units. That total represented a drop of about 10 percent from 1978 single-family production. The first quarter of 1980 saw the beginning of an apparent slump in single-family homebuilding, when permits dropped to a seasonally adjusted annual rate of 89,300, the lowest single-family total since the second quarter of 1975. It is likely that the second and third quarters of 1980 will see even lower levels of new home production, and that total single family volume will not exceed an annual rate of 100,000 units again until early 1981. The homebuilding industry, in California as well as nationally, is now feeling the effect of the record high interest rates that reached peak levels in late April or early May, when the prime rate on new conventional residential mortgage loans neared 18 percent at many California institutions. At such rate levels, a relatively small percentage of homebuyers were able to qualify for loans, and the volume of new home sales began to plummet. Although rates declined substantially during May, with most lenders posting rates of 13 percent or below by the end of the month, the damage had been done to the new home market, particularly on the supply side.

Builders had begun to get discouraged by late 1979, when the prime commercial lending rate at banks exceeded 15 percent during the fourth quarter. Most builders, being in a business that is historically regarded as somewhat risky and therefore subject to lending rates averaging at least two points above prime, had to pay from 18 to 22 percent for term construction financing during late 1979 and early 1980, and many chose to postpone any new groundbreaking until conditions were more favorable, probably late in 1980. The issuance rate for new single-family permits declined sharply in December, 1979, and again in March, 1980, when the seasonally adjusted annual rate of 64,700 units was only about half the rate for all of 1979. While borrowing costs for builders have since begun to decline, it is unlikely that construction will return to last year's rate again for another nine to twelve months, since the effects of the recession are now becoming widespread enough to make buyers cautious about undertaking new or increased debt burdens.

The housing boom that began in 1976 in California differed importantly from past cyclical expansions in the types of housing—mainly single family detached homes, townhouses, and other condominiums—that were emphasized. California had historically been an apartment market, and as recently as 1970, only 55 percent of Californians were homeowners compared with 63 percent nationwide. Since 1974, however, the mix of new housing has shifted sharply toward single-family units, with multiple units typically accounting for only about 40 percent of the total new residential units, compared with over 50 percent during the ten years preceding 1974.

Not only has the market shifted more toward single-family units; there has also been a compositional shift of multiple units away from rental dwellings toward ownership units, primarily condominiums. This compositional shift away from rental units has frequently been attributed to the widespread imposition of rent controls following the passage of Proposition 13 in 1978. While rent controls are undoubtedly operating to discourage apartment construction, it is also true that the trend away from rental units extends to areas not covered by controls, and predates Proposition 13 and rent controls by a number of years.

In addition to the recent impact of rent controls, it is likely that other, longer-term forces have been working against apartment construction. First, with the current maturation of the baby-boom population group, there has been an increase in the percentage of the population entering the typical home-buying age brackets. Additionally, it is likely that the recent experience with inflation has induced a generalized shift in preferences toward home ownership as both a good store of value and as a tax shelter. Finally, it is likely that the profitability of apartment ownership has never recovered from the over-production years of the early 1970s, when an apparent surplus of rental housing was created. About the time when investment began to be attractive again, the industry was hit with rent controls.

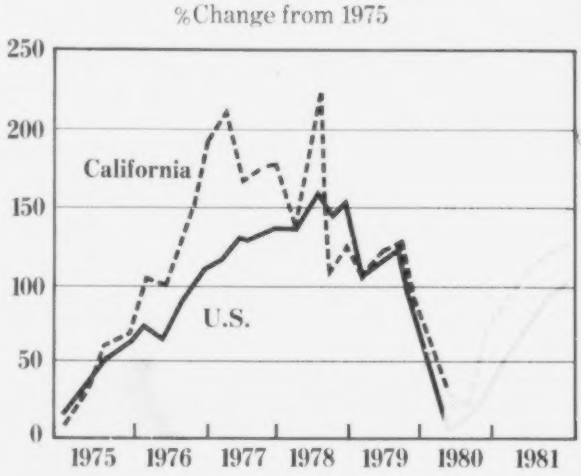
It is likely that the forces outlined above will continue to operate in favor of ownership units rather than rental units in the market for multiples. In total, multiple units should continue to account for about 40 percent of total housing units authorized during 1980 and 1981, with about 58,000 multiples expected during 1980, followed by a recovery to 90,000 units during 1981.

NONRESIDENTIAL CONSTRUCTION OUTLOOK

Nonresidential construction is not expected to be as severely depressed as homebuilding over the forecast period. However, high interest rates and credit curbs will take their toll and produce a downward trend in nonresidential construction in 1980, followed by a slow upturn in 1981.

The outlook for nonresidential construction will be determined largely by the cost and availability of capital. Recent tight credit has had a more severe impact on homebuilding than on the nonresidential sector. Funds committed for nonresidential projects prior to the imposition of tight credit are expected to finance the sector throughout much of the forecast period. Joint ventures will be much more commonplace in nonresidential financing for the 1980s. Spreading the risks makes the venture more palatable. Lenders are increasingly seeking combinations of equity options and mortgage lending or construction funding and mortgage lending. Life insurance companies—historically, major sources of financing for large commercial developments—have experienced short-term disintermediation (more money paid out on policy loans and settlements than received from premiums and penalties). Policy loan demand should decline with interest rates, releasing more money for nonresidential financing in 1980-81. Additional funds for small commercial developments are currently being diverted from the residential income market. Rent controls have motivated the former apartment house investor to shift to the neighborhood shopping centers and professional offices.

BUILDING PERMIT ACTIVITY



Strong year-to-year gains in January and February and moderate rises in March resulting in an increase in nonresidential building permit valuations in California climbed to a seasonally adjusted annual rate of $7.4 billion—27 percent above the same quarter last year. Reflecting the total economy's expected pattern nonresidential construction in California should drop significantly in the second and third quarters, beginning a slow ascent in the fourth quarter of 1980. However, total 1980 nonresidential building permit valuations should still fall about 12 percent short of those in 1979. The 22 percent year-to-year increase predicted for the sector in 1981 will bring that year's nonresidential construction back on a par with 1979.

Commercial construction in California continued strong for the first quarter of 1980. Building permit valuations for the quarter reached a seasonally adjusted annual rate of $3.3 billion—34 percent above the same period in 1979. It should be noted that this 34 percent gain is probably understated due to a revision in the classification of building permits. Beginning with data for 1980, permits for nonresidential alterations and additions valued at $100,000 and over are no longer classified as new construction. This change results in lower totals for commercial, industrial, and other (institutional) construction and higher totals for nonresidential alterations/additions. Most of the commercial activity in the first quarter was centered in permits for office buildings. A shortage of office space in many metropolitan areas created an unsatisfied demand which is likely to remain for some time. However, the supply side of the equation, dampened in March by high interest rates, inflation, and restrictive credit policies, is expected to deteriorate further during 1980. A decline of approximately 14 percent in commercial construction permit valuations is projected for 1979/1980. As the prohibitive interest rates decrease in 1981, commercial construction should increase—about 28 percent year-over-year.

Permit valuations for industrial buildings suffered the greatest setback in the nonresidential sector for the first quarter, 1980. As mentioned above, a revision in the classifications of building permits data in 1980 makes 1979 data not comparable. There was, however, a definite year-to-year decline in industrial building. Economic uncertainties, the homebuilding slump, high interest rates, and inflation have curtailed industrial construction in California for 1980. Decreases in homebuilding left many areas with inadequate housing for prospective industrial employees. Moratoriums have also been enacted to curtail industial expansion. As a result of these economic inhibitors, industrial building is expected to drop 41 percent in the state from 1979 to 1980. The 1980 plunge will likely be met by a resurgence in 1981—up an estimated 37 percent from the previous year.

An apparent oversupply of medical facilities in California contributed to the slowdown in institutional building for the first quarter of 1980. Coupled with the present restrictive financial climate, this excess reduced the building permit valuations for schools, churches, and hospitals from last year's first quarter totals. Institutional construction, which provides a low-monetary return, is traditionally sluggish in periods of high interest rates and inflation. It is one of the first nonresidential categories to decline and the last to recover. Institutional building should, then, continue to decrease in valuations from 1979 to 1980. Further declines are also anticipated in 1981, as the projected volume falls to $780 million from $920 million in 1980. The recovery period for institutional building is not likely to begin until 1982—trailing behind the other nonresidential categories.

A pervasive climate of economic uncertainties in 1980 led first quarter nonresidential remodelings to increase substantially over those of the same period last year. As new nonresidential construction declined for the first quarter, many businesses chose to renovate or expand their facilities. It is probable that this trend will continue throughout 1980. Permit valuation for remodelings will increase, while all other categories of nonresidential construction will decrease for the year. Predictions for 1981 show a slowing trend of expansion as remodelings rise at about the same rate as new nonresidential construction.

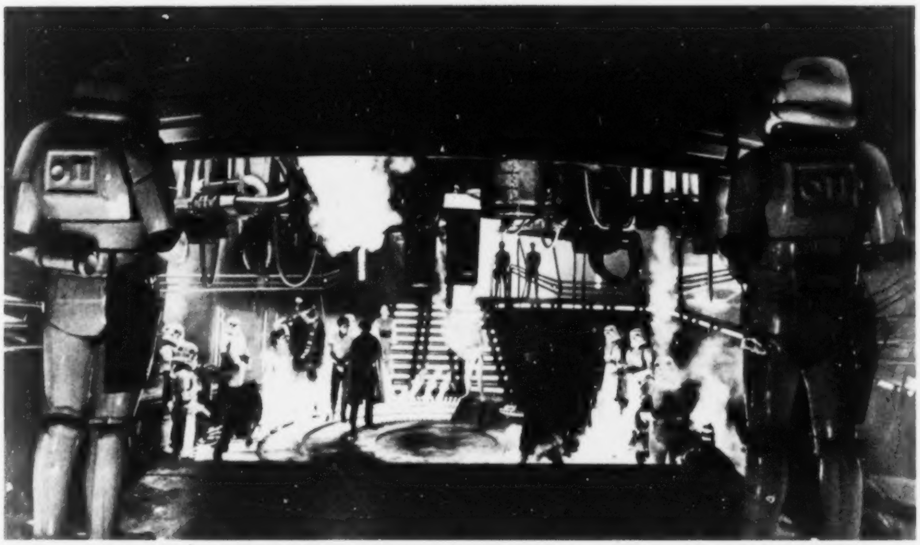
CALIFORNIA CONSTRUCTION FORECAST

				Annual Growth Rates		
	1979A	1980F	1981F	1978-79	1979-80	1980-81
New Housing Permits (000)	210.0	140.0	210.0	−13.9	−33.3	50.0
Single Units	127.5	82.0	120.0	−9.9	−35.7	46.3
Multiple Units	82.6	58.0	90.0	−19.3	−29.7	55.2
Total Valuation ($ mil.)	18,079	14,670	21,030	9.2	−18.9	43.4
Residential	10,789	8,280	13,250	1.7	−23.3	60.0
Single Units	6,886	4,990	8,230	1.6	−27.5	64.9
Multiple Units	2,802	2,270	3,580	−2.7	−19.0	57.7
Alterations	1,101	1,020	1,440	16.3	−7.4	41.2
Nonresidential*	7,290	6,390	7,780	22.4	−12.3	21.8
Commercial	3,376	2,920	3,740	36.3	−13.5	28.1
Industrial	1,812	1,070	1,470	16.4	−41.0	37.4
Alterations	720	1,480	1,790	18.9	105.6	20.9
Other	1,382	920	780	4.8	−33.4	−15.2

*Note: Beginning with data for 1980, permits for nonresidential alterations and additions valued at $100,000 and over are no longer classified as new construction, resulting in lower totals for commercial, industrial, and other construction and higher totals for nonresidential alterations/additions. Consequently, only total nonresidential valuations are strictly comparable with past data.

A = Actual F = Forecast

The Outlook for Inflation During the 1980s



Scene from "The Empire Strikes Back." The entertainment industry has lagged the overall inflation rate.

OVERVIEW

It is safe to say that inflation and inflation-related problems, such as high interest rates, are now a major concern of consumers and investors in California and the rest of the nation. While the nation has experienced several episodes of short-lived double-digit inflation in the past, the 11.3 percent rate of consumer price inflation experienced during 1979 was the highest recorded since the end of World War II and its tenacity is reflected in our forecast rate of a 14.1 percent increase in the national CPI for 1980. It is clear that inflation has recently been the main concern of economic policymakers in Washington and that the success or failure of current measures to counter inflationary forces may have a substantial effect on election-year politics. Indeed, without denying the seriousness of the problem, the recent preoccupation with inflation appears at times to obscure the transitory nature of some of the forces contributing to the current surge in prices.

THE PAST DECADE

Many people, when asked to guess the average inflationary rate in the United States since 1970, quote figures of 10 percent or more, which prove to be unrealistically high. While it may be prudent to give relatively greater weight to the most recent inflationary experience when making future financial decisions,it is also necessary to examine the longer-term trends from which recent experience may be, to some extent, a deviation. During the decade of the 1960s, consumer price inflation averaged only about 2.8 percent annually for the nation and about 2.6 percent per year in California, as measured by the Los Angeles area Consumer Price Index. Even with those low average rates of inflation, the experience of the second half of the decade differed sharply from that of the 1960-1965 period. Consumer price inflation nationally averaged only 1.3 percent per year during the first five years of the 1960s compared with an annual average of 4.2 percent for the second half of the decade. The inflationary surge during the late 1960s was due primarily to excess demand pressures in the economy generated by large federal government deficits related mainly to heavy defense spending associated with the Vietnam War.

Inflationary pressures abated slightly in the early 1970s before beginning another surge following the OPEC boycott of crude oil shipments to the U.S., and the subsequent inflation in virtually all energy prices, that began in the fall of 1973. Consumer price inflation averaged more than 10 percent annually during 1974 and 1975 and caused sharp disruptions in commodity and financial markets, resulting in the deepest recession of the postwar period. Energy commodities in the CPI increased over 38 percent during 1974 alone. Inflation moderated again during the 1976-1978 period, as energy prices returned to more manageable rates of increase.

Indeed, many people appear now to have forgotten that consumer price inflation averaged "only" 6.6 percent between 1975 and 1978, and that energy commodities lagged the overall inflation rate, increasing at an average annual rate of 5.5 percent during that three-year period. Other sources of inflation emerged during this period, however, as the costs of food, housing, and medical care all rose faster than energy costs. Unlike previous episodes in which inflation had been related to excess aggregate demand or acute bottlenecks in isolated sectors—such as energy—the relatively mild inflation of 1975-1978 had new, sinister characteristics: it was generalized, and it prevailed during a period when the economy had excess capacity.

CONSUMER PRICE INFLATION

All Urban Consumers
12 Months Ending April, 1980

Component	Inflation Rate (%) United States	Los Angeles	San Francisco
Food	7.3	6.5	6.2
Housing	17.3	22.7	19.4
Apparel & Upkeep	7.2	10.9	10.2
Transportation	21.6	22.0	24.3
Medical Care	11.4	15.7	13.0
Entertainment	8.6	8.0	13.8
Other	8.6	10.5	7.5
All Items	14.7	17.7	16.6

Source: U.S. Bureau of Labor Statistics

By early 1979, the rapid growth during the economic expansion since early 1975 had led to the reappearance of demand pressures in many sectors of the economy, which was now operating at near capacity rates of utilization for both capital and labor. Food prices began to exhibit the effect of short supplies of some commodities due to relatively poor harvests, compounded by an increase in world demand for our agricultural exports. Housing suffered the twofold ravages of cost increases for land and building materials and excess demand pressures created by the maturation of the postwar "baby boom" generation. A rapid increase in the cost of medical services had been fueled by massive government subsidization of medical care beginning in the late 1960s. The problem of inflation in medical care is one that warrants separate consideration, since it predates the general inflationary environment of the 1970s and is partly unrelated to the more widespread inflation of the past several years.

THE NEAR-TERM INFLATION OUTLOOK

It is now estimated that consumer price inflation in the United States during 1979 averaged 11.3 percent, with a 10.7 percent increase in the Los Angeles area. Further increases in the consumer index of 14.1 percent for the nation and 16.5 percent for the Los Angeles area are expected during 1980.

The higher inflationary trend for California, as may be readily seen in the accompanying chart, is of relatively recent origin. Historically, California has been a region of lower than average inflation, with lower food costs frequently having been cited as a main reason. During 1979, however, consumer price inflation began to accelerate in California. Indeed, the only factor that kept the Los Angeles CPI at a lower percentage gain for the year was the decrease experienced by the regional index during December, 1978, as a result of the Proposition 13-mandated property tax reduction.

The table shows that consumer price inflation in the Los Angeles area exceeded the national average by 3 percentage points during the 12 months ending in April, 1980, while the San Francisco region was almost 2 percentage points higher than the U.S. average. The Los Angeles inflation relate exceeded the national average for every component except food and entertainment, while San Francisco was lower than the nation only for the components of food and "other" goods and services. The housing area is one in which both San Francisco and Los Angeles, and particularly the latter, far exceeded the national increase in the CPI component. Not only was the Los

Angeles increase higher by 5.4 percentage points, it also receives a weight of 48 percent compared with the 44 percent given to housing in the national index.

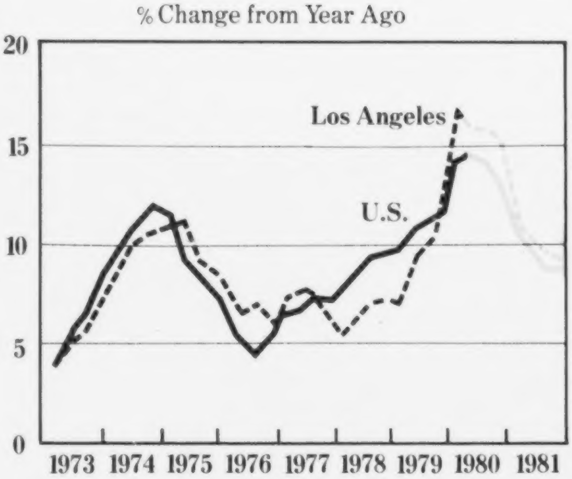
While cost pressures have operated to boost housing prices by a large percentage nationwide, those pressures have been augmented by heavy demand pressure in California. The high demand for housing in the state is related to the rapid growth in population and, especially, employment of recent years, coupled with supply restrictions such as stiff permit requirements and rent controls that have discouraged some types of residential projects in the state's major urban areas. It is likely that the state's rapid growth of recent years also contributed to demand pressures on other goods and services, such as health care, which were in relatively fixed supply during the short run.

Our inflation forecast for California in 1981 assumes the gradual moderation of the demand pressures and other factors that have caused prices to increase faster than nationally during most of 1979 and 1980. For the Los Angeles CPI, we are projecting a 10.5 percent increase, compared with the 10.2 percent rise expected for the nation. It should be noted that the realization of this convergent trend depends heavily on a return to normal levels of residential construction in California during 1981, since demand pressures on housing are continuing to build during the current period of low construction activity.

LONG-TERM INFLATIONARY FORCES

The higher inflationary experience of the 1970s, and in particular, of the 1973-1975 period, had some far-reaching effects on the decision-making behavior of households and businesses that will affect the outlook for the 1980s. First has been the national move toward "indexation"—the use of contractual arrangements including some escalator provision for the future years based upon an appropriate price index. Indexation is now commonplace in contracts such as collective bargaining agreements, long-term real estate leases, and personal damage settlements. Ironically, it was the lack of indexation in the tax system which led to the uprising known as the "Taxpayer Revolt" in California. Proposition 13, the property tax relief measure passed by California voters in June, 1978, was a direct populist response to allow for the impact of inflation on market valuation of real estate. Proposition 9, recently defeated on the June, 1980 ballot, also was considered by many to have been a response to the past lack of indexation in the state's progressive personal income tax. While it should be noted that the California personal income tax structure has been adjusted for inflation to some extent beginning in 1980, the adjustment does not begin to compensate taxpayers for the combined effect of inflation and progressive taxation during the preceding decade.

CONSUMER PRICE INDEX



The inflation of recent years has also had a dramatic effect on our collective expectations of future inflationary trends. Most people no longer assume that inflation will soon return to the relatively low and stable rates of the 1960s, as desirable an objective as that may be. Long-term interest rates now incorporate an inflationary premium that may be as high as 7 percent over a horizon as long as thirty years. While 7 percent inflation may seem mild in comparison with recent experience, there has probably never been an era in the history of the United States when inflation averaged 7 percent over a thirty year period.

It is clear that households and business firms have lately been placing their bets firmly on the side of continued high—perhaps even double digit—inflation during the 1980s. The remarkable strength of demand for real estate mortgage loans for all kinds of properties during 1979 is evidence of the widespread belief that real estate values not only will not decline, but will increase at a faster rate than prices generally.

It is our view that average rates of inflation during the 1980s will not be drastically higher than the average of the 1970s. Further, it appears that the worst sustained inflation of the decade may have occurred during the first half of 1980, assuming the success of current federal government policies to reduce inflationary pressures, particularly in labor and credit markets. However, as noted earlier, the underlying

or "core" rate of inflation is now clearly higher than at the beginning of the 1970s, and only a part of the current inflation is subject to domestic short-term policy. Crude oil prices, for example, are determined primarily in world markets and are largely beyond our control.

It appears likely that energy prices will continue to increase at a higher than average rate during the 1980s. In the opinion of many analysts, the price of oil and natural gas products were maintained at artificially low levels for many years, and are only now beginning to reflect true scarcity values in the United States. While the rate of increase of energy in the consumer price index should drop markedly from its current rate—an increase of over 50 percent during 1979 and 1980 combined—it could average 5 percentage points higher than the overall CPI inflation rate during the 1980s.

Housing costs may also outrun the CPI averages by a modest amount during the 1980s, although a continuation of the 20 to 30 percent annual increases in home prices seen in some areas during the late 1970s is highly unlikely. Some areas of the nation may actually see declining home prices in 1980 as the market adjusts to slower sales rates and generally tight credit conditions. For the 1980s as a whole, the costs of land, labor, materials, and credit will probably at least keep pace with inflation and continued strong demographic demand will place further continuing pressures on prices of new and existing homes during most of the decade.

On the plus side for households, costs of food (excepting energy-related components) and apparel should rise less than the overall rate of inflation during the 1980s. Markets for agricultural commodities continue to be more competitive than markets for many goods, with the result that prices for raw foodstuffs still decline when production exceeds demand, contributing to lower than average price increases over long periods of time. Apparel prices continue to benefit from intensive worldwide competition that makes it possible for the industry to restrain cost increases.

In summary, it is useful to view the inflationary problem in California and the nation as consisting of both transitory and core or longer-term components. Much of the recent increase in costs of energy, housing, and food is viewed as being transitory. Although those components are unlikely to decline in price during the 1980s, they should increase, on the average, less rapidly than recent experience has led many observers to expect. The core inflation rate in the consumer price index appears to have increased from perhaps 6 percent in the mid-1970s to about 8 or 9 percent currently. If the anti-inflationary measures now being applied by the federal government should succeed in lowering the core inflation rate by several percentage points over the next year or so, then there is a good chance that the inflationary trend of the 1980s will not be substantially worse than that of the 1970s, on the average. Whether or not the nation has the will to pursue the required difficult policies for a long enough time to reduce the core inflation rate is probably more a social and political question than an economic issue.

The U.S. Economic Outlook

Paul A. Volcker

The U.S. economy recorded two milestones during the early months of 1980. By May, the long-awaited start of the recession and the peak in interest rates apparently had occurred. The steepness of the declines in economic activity and interest rates has been dramatic, suggesting that the economy is entering into a business downturn that will be more severe than had been previously expected.

Tight Monetary Policies

Changes in economic policy—especially monetary policy—were responsible for the quickening in the economy's move to recession and for the violent swing in interest rates. Monetary policy, under the chairmanship of Paul A. Volcker, adopted an aggressively restrictive stance beginning in October, 1979, and the restrictiveness was augmented by moves on February 15 and March 14, 1980. The three-stage tightening was designed to slow the growth of the money supply and credit demand. Each action was followed by a sharp upward spike in interest rates, culminating in the 20 percent prime rate of early April. The money supply has been on a generally declining trend since mid-February, and by early May the aggregates were substantially below the Fed's lower growth target.

The future course of monetary policy will be dictated by conflicting forces. A marked easing would probably be inflationary, while continued restrictiveness would run the risk of aggravating the downturn. The Federal Reserve, however, is likely to maintain its policy of restricting the growth of the money supply to a 1980 rise of 3.5 to 6 percent for M1-A and 4 to 6.5 percent for M1-B. Specific interest rate targets should continue to be secondary policy goal. Thus, in order to boost the currently sagging money supply, the Federal Reserve probably will permit the federal funds rate, in the near term, to drift lower. From early April to early May, the fed funds rate fell over 800 basis points. Subsequent declines should be decidedly less dramatic. If inflation rates continue to persist at historically high levels, the Federal Reserve may seek to reduce its money supply targets for 1981 from the current growth rates.

A Balanced Budget in 1981?

Mr. Carter's March 14 economic message contained a commitment to a balanced budget in the 1981 fiscal year. Through a series of spending cuts and, most importantly, tax increases, the Administration aimed for a modest surplus in the 1981 budget. That promise, however, will be dashed by the rapid deceleration in economic activity and the marked rise in unemployment.

Additionally, Congressional approval of the proposed tax increases will be difficult to achieve. For example, the 10 cent a gallon tax on gasoline has been challenged in the federal courts, and the sharp rise in the unemployment rate will increase the pressure for a tax *cut*, not increases in taxes.

The following economic outlook does not include a specific cut in federal income taxes through 1981. The probability that a tax cut will be approved, however, increases as unemployment rises. The timing and specifics of a tax cut are largely political decisions, and it is difficult from an economist's viewpoint to determine precisely the date and size of a tax cut. Thus, although a cut is not included in the outlook, the probability is high that one will be approved—a factor that would boost real growth in 1981. The achievement of a budget surplus in the 1981 fiscal year will be very difficult, even without a tax cut, and, if the following economic outlook proves correct, a $31 billion deficit could occur—a deficit level that would be boosted by a cut in taxes.

Recent Economic Developments

Although real growth rose 0.6 percent in the first quarter, that expansion was primarily centered in federal government spending. The economy actually deteriorated over the course of the quarter. Industrial production fell 0.2 percent in February and 0.7 percent in March. Retail sales dropped 2.3 percent in March after falling 1.9 percent the month before. Housing starts plunged 22 percent in March, and the 1.04 million unit starts represented the lowest level since April, 1975. March's 2.6 percent decline in leading economic indicators was the steepest drop since November, 1974. Consumer confidence plummeted to the lowest level in the 34-year history of the University of Michigan survey. Despite the deceleration in economic activity, inflation rates accelerated in the first quarter, with both consumer and wholesale prices increasing at a monthly rate of 1.4 to 1.6 percent during the first three months of 1980.

Second Quarter Outlook

April's jump in the unemployment rate to 7 percent, the 1.7 million unit drop in that month's auto sales, the 1.2 percent decline in retail sales, and the 1.9 percent drop in industrial production are illustrative of an economy in recession. The credit-sensitive sectors of the economy have been squeezed by the Fed's tightening. Homebuilding and consumer spending on durable goods turned down in the first quarter, and a dramatic decline in these critical sectors should occur in the second quarter. In addition to the credit squeeze, the sharp rise in unemployment and the associated slowed growth in income will produce a sizable decline in total real consumer spending in the second quarter. Although the prospect of declining sales and the historically high interest rates instilled caution in inventory management, the sharp drop in sales may result in an involuntary buildup of stocks during the second quarter. Increases in inventory investment, therefore, may be a partial offset to a sizable decline in real final sales, but, even with the inventory accumulation, the second-quarter drop in total real output may exceed 6 percent.

THREE STAGES OF CREDIT TIGHTENING

October 6, 1979

- Shift policy focus away from federal funds rate targets to emphasis on money supply control.
- Increase in discount rate to 12 percent.
- Imposition of 8 percent marginal reserve requirement on bank managed liabilities.

February 15, 1980

- Increase in discount rate to 13 percent.

March 14, 1980

- Limit of 6 to 9 percent in the 1980 growth of bank loans.
- Establishment of a 3 percentage point penalty on the discount rate for heavy Fed borrowers.
- Increase to 10 percent in the marginal reserve requirement on managed liabilities of both member and nonmember banks.
- Imposition of a 15 percent reserve requirement on increases—since March 14—in outstanding consumer unsecured credit and in money market mutual funds.

Second Half 1980

The recent declines in interest rates and the dismantling of the credit control restrictions should gradually improve the financing environment for housing and consumer durable goods. Cutbacks in industrial output, however, should produce second-half declines in employment, and, thus, retail sales should remain under intense downward pressures throughout the remainder of this year. With credit availability generally improving, the declines in real output during the second half may be less than the sharp drop expected in the second quarter. Housing starts should increase over the second half, as declining mortgage rates allow an increasing number of potential homebuyers to qualify for mortgage loans. The desire for increased fuel efficiency should stem the decline in auto sales, with year-end sales up about a half million units from the second quarter lows. Efforts to trim inventory levels should proceed through the second half, resulting in lower production and an actual liquidation of inventories. Capital spending should decline, as current cutbacks in expansion plans and lower operating rates result in reduced real spending.

Prices to Moderate

The severe recession and declines in interest rates should result in lower inflation rates over the remainder of 1980. This outlook is based on the assumption that the 10 cent a gallon gasoline tax is not imposed during the second quarter. By the third quarter declining mortgage rates will contribute to a decelerating price trend. Additionally, production cutbacks and slumping sales should lessen demand pressures on prices. Sizable inventories of petroleum products should limit the rise in OPEC prices. Food prices, however, may increase at an accelerated pace during the second half of this year, due, in part, to the impact of high financing and operating costs holding down this year's planting.

Although inflation rates should moderate, the rates, even at year's end, should remain at an historically high level. Stimulative fiscal policies will contribute to a high underlying rate of inflation. Declines in productivity, coupled with workers' attempts to minimize the drop in real wages, should produce a rapid increase in unit labor costs. Consumer price inflation should moderate from the steep 16.8 percent average advance in the first quarter, but at year end, the rate should persist near 10 percent.

Cyclical Comparison

The recession is projected to persist through the final three quarters of 1980, resulting in a 3.4 percent drop in real output from the recession's peak to its trough. This 3.4 percent drop would be milder than the 5.7 percent peak-to-trough decline that occurred during the 1973-75 recession. In terms of the decline in real final sales, however, the projected 1980 downturn would be more severe than in the 1973-75 recession.

The consumer sector will be hit harder than in the prior recession, while the 1980 decline in housing will be only slightly less than in the last downturn. Considering that the homebuilding industry is not plagued by the speculative overbuilding that characterized the 1973-74 period, 1980's downturn will represent a major contraction for the industry. Since business in-

[illegible]

	1980				1981F			
	IA	IIF	IIIF	IVF	I	II	III	IV
Real Growth %	1.1	−6.0	−5.0	−2.3	1.6	2.4	3.1	3.8
Consumer Price Inflation %	16.8	15.2	11.5	9.6	10.0	9.7	9.6	9.5
Producers' Price Inflation %	17.0	12.7	13.1	9.1	12.2	11.1	10.0	9.7
Auto Sales +	10.7	8.5	8.7	9.0	9.4	9.6	9.9	10.4
Housing Starts +	1.26	0.90	1.00	1.10	1.25	1.40	1.55	1.70
Unemployment Rate %	6.1	7.2	8.0	8.6	8.9	8.7	8.3	8.1
Saving Rate %	3.4	4.0	4.4	4.4	4.3	4.3	4.4	4.3
Aftertax Profits $	154.0	138.5	128.0	124.0	119.0	120.0	125.5	131.5
% Change	20.8	−34.6	−27.1	−11.9	−15.2	3.4	19.6	20.5
% Change Year Ago	8.5	−0.6	−13.7	−15.6	−22.7	−13.4	−2.0	6.1
Prime Rate %	16.58	16.40	11.25	9.50	9.00	9.00	9.25	9.50
90 Day CD Rate %	15.04	11.65	8.21	7.50	7.50	7.50	7.75	8.00
Federal Funds Rate %	14.88	12.61	8.75	8.00	7.75	7.75	8.00	8.25
90 Day Commercial Paper Rate %	14.46	11.20	8.25	7.25	7.25	7.25	7.50	7.75
Moody's AAA Corp. Bond Rate %	12.14	11.20	10.50	9.75	9.50	9.50	9.50	9.75
Conventional Mortgage Rate %	12.54	12.00	10.75	10.25	10.00	10.0	10.00	10.25

+ = Millions of units $ = Billions of dollars A = Actual F = Forecast

[illegible]

(% Change Peak-Trough)

	Recession		Average of Postwar Recessions
	1980F	1973-75	
Gross National Product	−3.4	−5.7	−2.4
Consumer Spending	−2.4	−2.3	1.0
Capital Spending	−8.9	−15.6	−10.3
Housing Starts	−50.3	−63.6	−37.0
Aftertax Profits*	−22.7	−27.0	−24.1
Final Demand	−3.0	−2.2	−1.0

F=Forecast *Current $

ventories through the first quarter have been managed conservatively relative to sales, the current lack of excesses should result in an inventory correction that is less pronounced than in the 1973-75 period. Capital spending also has not experienced the excesses that preceded the prior business downturn. Thus, although spending plans should be trimmed in response to declining sales, the 8.9 percent peak-to-trough decline in capital spending would compare mildly to the drop in the last recession.

The pattern of the 1980 recession will contrast greatly with the 1973-75 recession. The prior recession could be classified into two contractions—a mild, credit-induced downturn for the first three quarters and a sharp inventory cycle in the final two quarters. It was almost three quarters into the recession that most observers concluded that the 1973-75 recession was in progress. In contrast, the 1980 recession is a "front-loaded" downturn, with precipitous declines in output and dramatic increases in unemployment characterizing the beginning of the downturn.

[illegible]

The expected moderating of the inflation rate to the 10 percent level and the drop in interest rates should stimulate a modest pickup in spending, and an economic recovery may be underway by early 1981. Solving the inflation and financial problems that have plagued the economy for nearly five years, however, will show very slow progress. Since inflation rates will remain at an historically high level, interest rates will probably not decline to levels traditionally associated with the beginning of an economic rebound. The relatively high inflation rates and the overextended debt positions of consumers and corporations should produce a 1981 economic recovery that is quite mild. Although real output should be rising throughout next year, real output in 1981 will average the level estimated for 1980. This projection of no growth in 1981 will translate into a rise in the average rate of unemployment to 8.5 percent from this year's estimated rate of 7.5 percent.

[illegible]

This period of economic slackness should temper inflationary pressures and the rate of consumer price inflation should average 10.2 percent higher in 1981, compared with 1980's 14.1 percent rise. On a quarterly basis, consumer price inflation rates should be considerably below the average for the year. Barring a major disruption in the flow of imported oil, the rise in OPEC prices should slow to about the prevailing rate of inflation. The decontrolling of the price of domestically produced petroleum, however, will push up the cost of oil products in the U.S.

[illegible]

Rising effective income tax rates, coupled with steep increases in social security taxes, should cut into consumer purchasing power, especially early in 1981. The expected recovery in car and other retail sales should be moderate, due to continued high rates of unemployment, the overextended consumer debt position, and the low saving rate. Inflation adjustments to social security benefits and gradual gains in employment should stimulate second-half sales. Additionally, the promise of greater fuel-efficiency in the 1982 model cars should encourage car sales late next year.

Homebuilding activity should provide significant support to the 1981 economy. The underlying demand for housing is quite strong due to age group/population trends. Although mortgage rates should remain at an historically high level during 1981, the aftertax, after-inflation cost of a home purchase may appear attractive. Thus, some sales that were lost during 1980's very high interest rate environment may be realized in 1981.

Capital spending in 1981 should continue to suffer from the effects of high rates of inflation and long-term financing costs. Two down years for corporate profits will mean that companies will have to rely increasingly on external sources for their financing. Although the rate of inflation should moderate over the course of 1981, the inflation premium embodied in long-term interest rates probably will remain at an historically high rate, thus discouraging a marked rise in new capital expansion plans. The decline in real capital spending that is projected to begin in the second quarter of 1980 should continue through the first half of 1981, producing a nearly 9 percent decline in spending from peak to trough.

Federal defense spending should provide some support to the 1981 economy, but efforts to cut government spending should translate into a slowing in the growth of government purchases following 1980's estimated 5.7 percent rise. Increases in defense spending, however, will be a factor boosting inventory levels, and additions to inventories will provide some support to total real output next year in contrast to the decline that is expected for real final sales in 1981.

Corporate profits may record a second consecutive annual decline during 1981, although, on a quarter-over-quarter basis, profits should be increasing by mid-1981. The declines on a year-over-year comparison, however, will not be stemmed until the fourth quarter. The expected moderating in the rate of inflation will be a factor in 1981's profit decline. As inflation rates slow, the inflation adjustments to profits—namely inventory profits and the underdepreciation of capital assets—will decline. Reported aftertax profits are expected to decline about 8 percent in 1981 following a 5.4 percent drop this year. Meanwhile, operating profits, which exclude the inflation adjustments to profits, are projected to decline 7.3 percent next year after an 18.4 percent drop in 1980.

[illegible] U.S. ECONOMIC OUTLOOK

(Billions of Dollars)

	79A	% Chg.	80F	% Chg.	81F	% Chg.
Gross National Product	2,368.8	11.3	2,571.8	8.6	2,830.7	10.1
Personal Consumption Expenditures	1,509.8	11.8	1,674.0	10.9	1,843.9	10.1
Durable Goods	213.0	6.3	211.3	−0.8	225.4	6.7
Autos & Parts	91.5	0.3	85.2	−6.9	95.0	11.5
Except Autos & Parts	121.5	11.4	126.1	3.8	130.4	3.4
Nondurable Goods	596.9	12.5	676.0	13.2	746.5	10.4
Services	699.8	12.9	786.7	12.4	872.0	10.8
Gross Private Domestic Investment	387.2	10.2	366.3	−5.4	393.6	7.5
Fixed Investment	369.0	12.1	365.9	−0.8	388.0	6.0
Nonresidential	254.9	15.3	272.3	6.8	284.0	4.3
Producers' Durable Equipment	162.2	12.2	169.0	4.2	178.2	5.5
Structures	92.6	21.1	103.3	11.5	105.8	2.4
Residential	114.1	5.7	93.7	−17.9	104.1	11.2
Change in Business Inventories	18.1	—	0.4	—	5.9	—
Government Purchases	476.4	9.4	536.6	12.6	599.0	11.6
Federal	166.6	9.2	193.9	16.4	218.0	12.4
Defense	108.3	9.4	124.9	15.3	143.5	14.9
Nondefense	58.4	9.0	69.0	18.2	74.5	8.0
State & Local	309.8	9.5	342.6	10.6	381.0	11.2
Net Exports	−4.6	—	−5.1	—	−6.0	—
Gross National Product (1972 $)	1,431.6	2.3	1,416.3	−1.1	1,416.0	0
Implicit Price Deflator	165.5	8.8	181.6	9.7	199.9	10.1
Final Demand	2,350.7	10.5	2,571.4	9.4	2,824.9	9.9

A=Actual F=Forecast

NATIONAL OUTLOOK EDITION

NUMBER 61

This report highlights the outlook for the United States' economy through 1981.

Subsequent issues of the ECONOMIC REPORT will discuss the following topics:

1981 International Outlook, December 1980
Long-Term U.S. Outlook, March 1981
1982 California Outlook, June 1981

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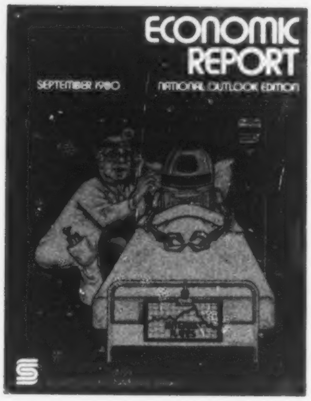

ECONOMIC REPORT

SEPTEMBER 1980

3

HEALTH OF THE ECONOMY: A FIRST HALF REVIEW

The first half of 1980 was a period of dramatic developments for the U.S. economy. Interest rates rose to record heights, while the rate of inflation skyrocketed. The economy reached a cyclical peak in January and swiftly fell into a deep recession. The first-half economy produced some interesting fiscal and monetary policy responses, capped by an unprecedented peacetime imposition of credit controls.

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PROGNOSIS FOR THE ECONOMY

The recession may extend into the fourth quarter of 1980, although the second half decline in economic activity will be decidedly more moderate than the 9 percent drop in the second quarter. The 1981 economy should be a year of mild recovery. Continued high rates of inflation will put a squeeze on the purchasing power of consumers, thus holding down the cyclical exuberance in retail sales and homebuying. Corporations will be plagued by declining corporate earnings and the relatively high cost of external financing.

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ECONOMIC POLICY PRESCRIPTIONS

The election year of 1980 did not elicit the old-time medicine of tax cuts and spending programs to bolster the slumping 1980 economy. A tax cut is likely in 1981, but the exact form of that cut will depend on the outcome of the November elections. Monetary policymakers will face the difficult challenges posed by a fragile economic recovery and continued high rates of inflation.

Summary

The U.S. economy entered into recession in the early months of 1980, and at midyear had undergone the postwar's steepest downturn for the beginning stages of a business contraction. This first-half period was characterized by record high interest and inflation rates and by sharp increases in the rate of unemployment. The combination of soaring inflation and unemployment rates presented difficult challenges to fiscal and monetary policymakers, with some programs designed to restrain economic activity and inflationary pressures replaced by proposals to stimulate the economy. The unprecedented peacetime imposition of credit controls contributed importantly to the sharp downturn in economic activity during the second quarter, while their removal is providing some strength to the third-quarter economy.

The economy may remain in recession into the fourth quarter of 1980, but the decline in business activity will be considerably milder than the second quarter's experience. Recoveries in consumer spending and homebuilding are already underway but will be offset by cutbacks in business capital and inventory spending.

The 1981 economy should experience a year of recovery, but that recovery will rank as the slowest upturn of the postwar business cycle history. Inflation rates above 10 percent will hold down the purchasing power of both consumers and corporations, thus checking the economic upturn. Additionally, taxes are scheduled to increase sharply in 1981, reflecting the increase in social security taxes, the windfall profits tax, and the inflationary push of taxpayers into higher tax brackets.

The sluggishness of the economic upturn, unemployment rates above 8 percent, and the growing tax burden should lead to some tax relief during 1981. The precise form of the tax cut will hinge on the outcome of the 1980 Presidential elections. Congressional debate of the various tax proposals will probably delay the implementation of a tax cut at least until the second quarter of next year, thus the early 1981 economy may be quite sluggish.

With inflation rates continuing near double-digit rates, monetary policymakers probably cannot veer far from a policy of restraint. Thus, although interest rates may decline from current levels due to a softening in credit demand, both short- and long-term interest rates should persist at historically high levels throughout the forecast period. The expansion in economic activity combined with large federal government financing requirements should produce an upturn in interest rates by the second half of next year.

Health of the Economy– A First Half Review

The first half of 1980 brought many dramatic economic developments. Interest rates went on a roller coaster ride, with record highs and dramatic declines occurring within a period of weeks. Inflation rates soared to historic levels catapulted by increased OPEC oil prices and skyrocketing mortgage costs. The economy finally reached the end of the expansion that began in early 1975, and the descent into recession was precipitous. After a year of virtually no change, the jobless rate experienced two months of quantum leaps, pushing the rate near 8 percent.

POLICY ACTIONS

Economic policymakers viewed the first half as a time for action, but exactly what kind of action was a difficult determination. The early weeks of 1980 showed few signs that the economy was slowing. The year-end 1979 pickup in consumer spending continued into January. Auto sales climbed 1.1 million units in January to a near-term high of 11.7 million units, while total retail sales rose an impressive 3 percent. Speculative pressures were rampant and the commodity markets, especially those for gold and other precious metals, recorded new heights in prices. Early in the new year concerns were raised that the recession may still be off in the distance and that curbing demand and speculative pressures must be the highest priority of economic stabilization policies.

To stem these speculative pressures, a series of tightening measures were adopted by the Federal Reserve beginning last October and were culminated by President Carter's March 14th announcement of an anti-inflation program. The real teeth to this program was carried by the Federal Reserve through the imposition of selective credit controls. The establishment of reserve requirements on increases in unsecured consumer credit and on various types of monetary transactions and new Fed limits on desired 1980 loan growth combined to push up the cost of credit and, thus, deter borrowing activity.

The March 14th anti-inflation program also contained recommendations for increases in tax revenues, cuts in government spending, and a surplus in the 1981 federal budget. The tax changes included a 10 cent a gallon increase in the federal gasoline tax, methods to speed tax collection, and the establishment of tax withholding on interest and dividend income. These tax proposals did not receive either judicial sanction or legislative approval. Instead, the swift descent into recession changed the calls for tax increases to calls for tax decreases.

The cuts in spending became an unattainable goal for both fiscal 1980 and 1981. Sharp increases in unemployment boosted federal assistance payments. Additionally, disaster relief, bailouts to ailing corporations and financial institutions, and assistance to workers displaced by foreign competition triggered increases in spending for both fiscal years. With the unemployment rate nearing 8 percent, job creation plans are being circulated through Washington. Thus, rather than a $16 billion surplus, the 1981 federal budget could be in deficit by more than $30 billion, even without a provision for a tax cut.

Consumer Spending

The credit controls put an effective stop to a consumer sector that was already showing signs of weakening. Even before the credit controls took effect, retail sales went on the skids. Auto sales plummeted to a 20-year low. Increases in the cost of consumer credit and restrictions on the availability of new credit contributed to a record liquidation of consumer debt during the second quarter. Spending declined throughout the consumer sector. Even the cyclically-immune service sector experienced an 0.8 percent decline in real spending during the second quarter. Spending on nondurable goods fell 5.5 percent in real terms, led by decreases in gasoline and fuel oil purchases. By far the most dramatic correction in second-quarter spending occurred in the durable goods sector. Real spending on autos and parts plummeted at an annual rate of 67.1 percent. Declines in home sales caused real spending on furniture and appliances to fall 15.5 percent, while sharply higher prices for jewelry and the high cost of financing caused other durable goods spending to drop 21.8 percent.

In addition to the credit-induced weakness, the consumer sector was adversely affected by continued high rates of inflation and rising unemployment rates. Concern over job security caused consumers to save an increased portion of their income. The saving rate rose from 3.7 percent in the first quarter to 4.8 percent in the second quarter. This rise in the saving rate occurred despite persistent declines in wage and salary income during the second quarter and the continued cost pressures on family budgets produced by rapid increases in consumer prices.

Housing Sector

Homebuilding was the hardest hit sector of the first-half economy. The credit tightening that was initiated in October, 1979 quickly affected housing starts. The sharply higher cost of mortgage financing and the reduced flow of savings into thrift institutions triggered a deep contraction in new homebuilding. Housing starts had reached a near-term high of 1.87 million units in September, 1979 and fell to a five-year low of 0.92 million units in May of this year. Record high mortgage rates caused many potential homebuyers to be unable to qualify for mortgage loans; thus, home sales plummeted this spring.

Interest rates, however, began a dramatic descent in early April and mortgage rates shared in the sharp rate declines. Regulatory changes allowed savings institutions to pay above-money market rates on 6-month $10,000 money market certificates and on 2½ year passbook accounts, thus causing savings to flow back into thrift institutions. Housing starts apparently reached a bottom in May, as a pickup in home sales and increased federal subsidies for housing boosted construction activity. During the second quarter, however, real spending on residential construction fell at an annual rate of 61.8 percent, the steepest downturn of the postwar history.

Business Spending

Capital spending reacted to the sharp rise in financing costs and the declines in consumer spending. Following a modest gain the first quarter, real spending on nonresidential fixed investment during the second quarter fell 15.4 percent, led by a sharp curtailment in business purchases of fleet cars and trucks. The 18.4 percent decline in real spending on equipment was largely due to the dropoff in transportation equipment spending, although cutbacks were reported in spending for many other types of equipment. Reflecting a steady decline in industrial building permits, nonresidential construction fell 9.2 percent.

Sizable declines in industrial production, in part to adjust inventory levels to the reduced sales activity, caused factory operating rates to fall to a five-year low. The underutilization of existing production facilities, coupled with historically high financing rates, triggered many companies to scale back spending plans. Additionally, the Federal Reserve's lid on loan growth caused many banks to hesitate in committing funds for future financing. When interest rates began to decline in April, many companies rushed to get intermediate and long-term financing in an attempt to restructure balance sheets away from a dependence on the oftentimes volatile short-term financing. A record corporate bond calendar, however, quickly drove up long-term interest rates, and many companies decided to defer, or cancel, financing and capital spending plans.

Since a recession had been a feature of most economic projections for more than a year, many businesses had factored into their production plans an impending cutback in sales. Thus, inventories were monitored closely, and, on balance, stocks remained lean relative to sales at least through the first quarter of 1980. Inventory excesses did develop before the second quarter of this year, notably in the auto industry, but the inventory-to-sales ratio for the total business sector showed steady declines through the first quarter of this year. The marked contraction in sales during the second quarter, however, caused inventories to accumulate, triggering an upturn in the inventory-to-sales ratio.

Government Spending

Federal government spending was the major and oftentimes only source of growth to the first-half economy. Defense spending was boosted by the buildup of military expenditures associated with the Iranian hostage/Afghanistan crises and a renewed commitment to rearmament and defense spending. Meanwhile, nondefense spending on goods and services rose, in part due to the special circumstances associated with the Russian grain embargo, the Mount St. Helens eruption, and the large influx of Cuban and Haitian refugees. Real federal government spending rose 13.3 percent in the first quarter and 10.3 percent during the second quarter.

In contrast to the support provided from the federal sector, state and local government spending has aggravated the downward pressures on economic activity during the first half. Real spending by state and local governments fell 0.7 percent in the first quarter and 3.1 percent in the second period. Announced cutbacks in the federal revenue sharing program, fear of potential voter restrictions on spending growth and revenue generation, and record high municipal bond rates contributed to the declines in real spending.

Foreign Developments

The U.S. net export position improved substantially over the first half. Sharply higher imported oil prices and an acceleration in foreign car sales contributed to a widening in the deficit position during the first quarter, with net exports in the red by $13.6 billion. The deficit narrowed to $2.5 billion in the second quarter, as decreased oil consumption slowed the pace of oil imports and a slump in car sales cut into the demand for imported cars. Exports grew briskly during the first quarter, and, although slowing economic activity abroad curbed the demand for exports, the drop in export volume during the second quarter was substantially less than the decline in real imports.

The dollar recorded an erratic performance during the first half of this year, with its movements closely paralleling the movement of short-term interest rates. Early in the year, concern over possible further Russian invasions following the takeover of Afghanistan caused the dollar to rally, with investors attempting to reduce holdings of Continental assets. Soaring U.S. interest rates during the spring augmented the rise in the dollar. The subsequent drop in U.S. interest rates was not immediately matched by declines in interest rates for British, German, Japanese, and other major countries' short-term investments. Thus, the dollar slumped on foreign exchange markets into the summer months. The early August turnaround in U.S. interest rates has brought some renewed strength to the dollar.

PRICE TRENDS

Inflation rates skyrocketed early in 1980, with consumer prices up at annualized rates of 17 percent in the first quarter and 13.7 percent in the second quarter. Based upon the government's method of measuring price changes, consumer prices were up 18.1 percent for the three months ending in March and 11.6 percent for the March-June period. Wholesale prices for finished goods experienced a 13.7 percent advance in the first quarter and a 9.4 percent rise in the second period.

Sharply higher prices for petroleum products reflected a step-up in OPEC prices and the price decontrol of domestically produced petroleum. On a year-over-year basis, OPEC prices registered increases of 108 percent in the first quarter and 78 percent in the second quarter. Prices of domestically produced petroleum were up 86.5 percent in the year ending in the first quarter and 84.4 percent for the second-quarter comparison. This rise in oil prices contributed to the 17.5 percent surge in consumer transportation costs for the year ending June, 1980.

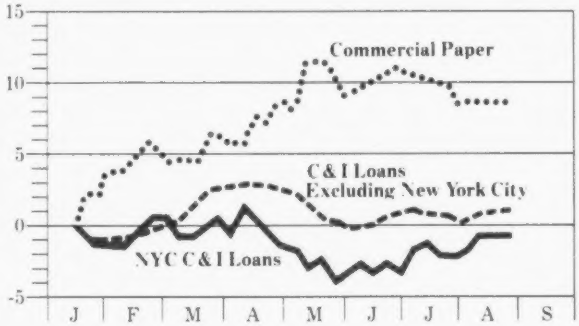
The sharpest price rise occurred in the housing sector, where record high mortgage rates and continued increases in home prices contributed to an 18.3 percent rise in housing costs during the year ending in June. Although mortgage rates began to decline in April, these financing costs enter the CPI calculation with a lag, reflecting the length of escrows. Thus, the April-May declines in mortgage rates did not begin to be reflected in the index until July.

Food price inflation was surprisingly modest during the first half. The Russian grain embargo held down grain prices by increasing domestic supplies. Additionally, high short-term interest rates increas-

FIRST HALF PRICE TRENDS
Annual Percent Changes

Consumer Price Index	3 Months Ended March 80	3 Months Ended June 80	12 Months Ended June 80
All Items	18.1	11.6	14.3
Food & Beverages	4.3	5.8	7.2
Housing	19.5	20.6	18.3
Apparel & Upkeep	15.3	0.5	6.9
Transportation	35.2	2.5	17.5
Medical Care	15.9	7.3	11.4
Entertainment	15.0	8.4	9.1
Other Goods & Services	10.6	8.9	9.3

CHANGE IN SHORT-TERM BUSINESS CREDIT MEASURES SINCE EARLY-1980
(percent)



ed the cost of maintaining cattle on feed and, thus, an early slaughtering of cattle stocks slowed the rise in meat prices. Although the first half showed some respite in the upward spiral of food prices, bad weather and reduced cattle herds are laying the groundwork for a second-half acceleration in food price inflation.

FINANCIAL DEVELOPMENTS

The Federal Reserve's tightening measures in October, 1979 and February and March, 1980 preceded sharp spikes in interest rates. Expectations of future tightness in the availability of money caused loan demand to increase briskly during the December through February period. Business efforts to secure future financing requirements caused the growth in commercial and industrial loans to exceed 30 percent for the four weeks ending December 26, 1979 through the four weeks ending February 27, 1980. That growth occurred despite a prevailing prime rate of at least 15.25 percent.

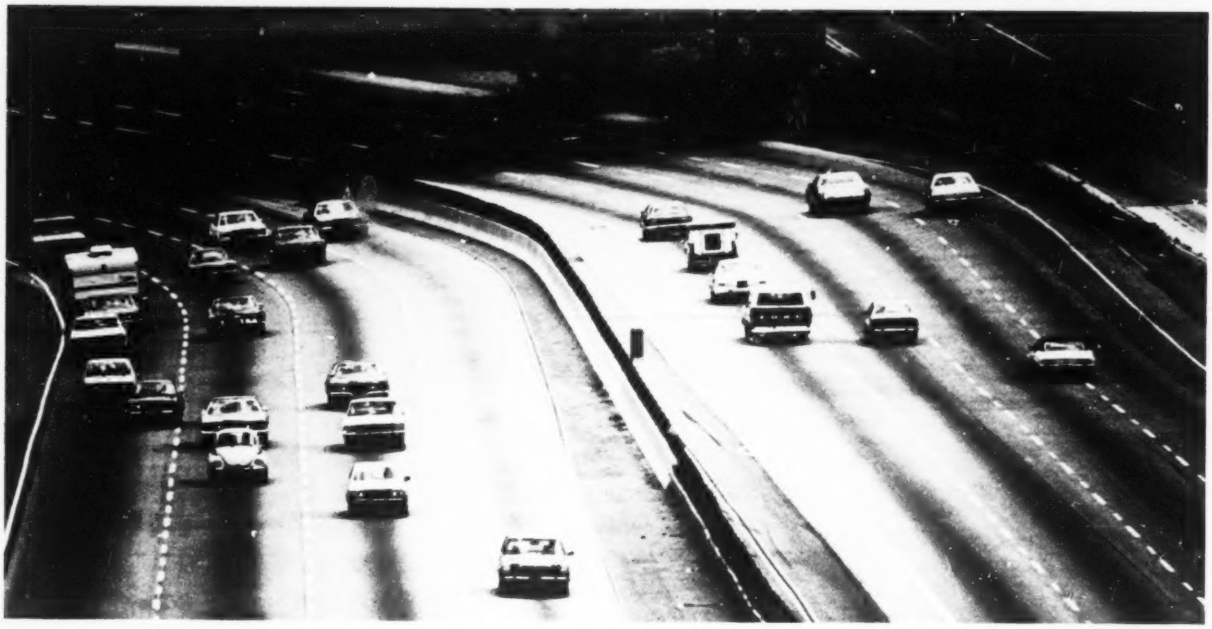
The monetary features of the March 14th anti-inflation program and the soaring of the prime rate to a record 20 percent helped moderate business loan demand. Additionally, the steep slide in economic activity, during the second quarter effectively reduced credit demand. Business loans dropped by more than 11 percent during the mid-March through mid-May period. This slackening in credit demand contributed to a dramatic drop in interest rates, with short-term rates falling between 600 to 1000 basis points from early April through May.

Trends in the money supply patterned the early 1980 loan activity. Growth in the money stock for both M-1A and M-1B exceeded the Federal Reserve's growth targets by early February and remained above the range throughout the month. The free fall in economic activity that characterized the second quarter caused the money stock to fall sharply below the lower bounds of the Fed's targets in late April. The monetary aggregates remained substantially below desired levels throughout the remainder of the second quarter, causing the Fed to increase reserves to the banking system in an attempt to get the money supply back on target. This influx of reserves and the sharp contraction in economic activity helped to keep a lid on interest rates, notably short-term rates, during the latter part of the second quarter.

In a stair-step fashion, the prime rate declined from its record 20 percent high to a near-term low of 11 percent, while the rate on federal funds fell from around 19.25 percent in early April to a low of 8.68 percent in mid-July. The peak in T-bill rates occurred before the peak in other short-term rates, and a bottom was reached early in June, following a nearly 900 basis points plunge in the rate.

Long-term interest rates peaked about the same time as short-term rates, while a near-term bottoming in long-term rates apparently occurred about the same time as the bottoming T-bill rates. With long-term rates receding from such record heights as 13 percent for AAA-rated corporates and 14¾ percent for BAA corporates, increased demand for long-term financing produced a sharp expansion in the size of the corporate bond calendar. Corporate efforts to restructure debt away from short-term financing greatly boosted the demand for long-term funds. The sizable bond calendar, however, and fears of a re-igniting of inflationary pressures triggered steady increases in long-term rates since mid-June and an eventual reduction in new bond offerings.

Prognosis for the Economy



The Summer Rebound or Life After Credit Controls

When this business cycle becomes history, the disruptive force that the credit control program had on the economy will probably be clearer. The second quarter's steep 9.8 percent drop in real consumer spending and the record liquidation of consumer debt represented a sharp reaction to the March 14th imposition of credit restrictions. The controls aggravated a downturn that was already taking place in consumer buying. Conversely, the removal of controls coincided with a record cost-of-living adjustment to social security benefits and other government entitlement payments. Thus, economic activity in July benefited from many special factors.

The economy is experiencing a temporary rebound following the lifting of the credit controls, but the sharp gains in July probably will not be repeated in the months ahead. Following four months of declines, retail sales expanded 1.4 percent in June and 2 percent in July. Car sales rose 1.5 million units in July to the highest rate since last March. Employment expanded in July for the first time in four months, while personal income surged by 1.4 percent in the month. The decline in industrial production subsided somewhat in July, and orders for durable goods recorded an impressive 8.4 percent advance after five months of steep declines. The index of leading indicators climbed 1.5 percent in June and a record 4.6 percent in July.

Is The Recession Over?

Although these economic advances suggest that the economy is near recovery, declines in economic activity appear likely in the months ahead. The flattening in the unemployment rate around May's 7.8 percent level may be merely a lull, reflecting the difficulty in adequately adjusting for seasonal employment patterns during the summer rather than a turnaround in employment demand. The bulge in July's personal income growth obscured a continued decline in wage and salary income. During the remaining months of the third quarter, the rise in income will be modest,

THE U.S. ECONOMIC OUTLOOK
($ billions)

	1979A	Percent Change	1980F	Percent Change	1981F	Percent Change
Gross National Product	2368.8	11.3	2553.5	7.8	2805.1	9.8
Personal Consumption Expenditures	1509.8	11.8	1663.3	10.2	1840.4	10.6
Durable Goods	213.0	6.3	207.5	-2.6	227.4	9.6
Autos & Parts	91.5	0.3	82.2	-10.2	98.1	19.3
Except Autos & Parts	121.5	11.4	125.3	3.1	129.3	3.2
Nondurable Goods	596.9	12.5	664.6	11.3	728.5	9.6
Services	699.8	12.9	791.2	13.1	884.5	11.8
Gross Private Domestic Investment	387.2	10.2	360.2	-7.0	385.2	6.9
Fixed Investment	369.0	12.1	362.9	-1.6	355.2	6.1
Nonresidential	254.9	15.3	268.7	5.4	279.4	4.0
Producers' Durable Equipment	162.2	12.2	165.8	2.2	173.7	4.8
Structures	92.6	21.1	102.9	11.1	105.6	2.7
Residential	114.1	5.7	94.2	-17.4	105.9	12.4
Change in Business Inventories	18.1	—	-2.7	—	0	—
Government Purchases	476.4	9.4	534.7	12.2	589.9	10.3
Federal	166.6	9.2	195.4	17.2	218.0	11.6
Defense	108.3	9.4	126.2	16.5	144.5	14.5
Nondefense	58.4	9.0	69.2	18.5	73.5	6.2
State & Local	309.8	9.5	339.4	9.6	371.5	9.5
Net Exports	-4.6	—	-4.8	—	-10.1	—
Gross National Product (1972 $)	1431.6	2.3	1412.5	-1.3	1414.7	0.2
Implicit Price Deflator	165.5	8.8	180.8	9.3	198.3	9.7
Final Demand	2350.7	10.5	2556.2	8.8	2805.1	9.7

A=Actual F=Forecast

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reflecting an expected decline in employment and the absence of July's 14.2 percent inflation adjustment to social security benefits.

The rise in the inventory-to-sales ratio during June suggests that inventory liquidation is still required in many areas of the economy, notably among durable goods wholesalers and manufacturers. Cutbacks in production and employment demand, therefore, will characterize the next few months, with the unemployment rate likely to exceed 8 percent by the end of this quarter. The capital spending sector should experience a recovery in fleet purchases of motor vehicles, but spending on construction and heavy industrial equipment will be held down by past declines in nonresidential building permits and new orders.

Financial Markets and the Third Quarter Economy

The recent runup in interest rates is contributing to speculation that the recession is over. Again, the credit control program could be the culprit behind the volatility in interest rates. The controls aggravated the second-quarter decline in economic activity and, thereby, probably reduced credit demands by more than would be warranted by the economic fundamentals, i.e., the economy without credit controls. If the removal of controls is responsible for a temporary pickup in economic activity, credit demands may also have been boosted artificially. The credit controls probably brought interest rates lower than they would have gone without controls, while the removal of controls is now bringing rates closer to the level implied by the economic fundamentals.

Long-term interest rates are reacting to the early summer's record corporate bond calendar as well as to the worsening in the inflation outlook. Long-term rates increased in mid June and climbed steadily through the summer. This upturn in long-term corporate financing costs is reducing the size of the corporate bond calendar and forcing many companies to return to the short-term markets for financing. The increase in business loan demand, in turn, is adding to the upward pressures on short-term rates.

OUTLOOK FOR REAL GROWTH

The U.S. economy probably will remain in recession throughout most of the second half of this year. Fragile recoveries in consumer spending and homebuilding will be offset by declines in real capital spending and a liquidation of business inventories. Thus, real output should decline in the third and fourth quarters, but at substantially slower rates than the second quarter's 9 percent plunge. The recession is projected to produce a 3.5 percent drop in real output from the business cycle's peak to its trough, making this recession the second most severe downturn of the postwar history. In terms of the expected contraction in both consumer spending and real final sales, this recession will be the most severe in recent history.

Steady declines in real spending on residential investment will make this sector the weakest area of the 1980 economy, with spending off 24.7 percent. This drop in residential construction will combine with declines in equipment spending and a flattening in nonresidential construction spending to produce a 9.2 percent drop in fixed investment spending this year. Adding in a liquidation of business inventories, the total investment sector should register a 14.7 percent drop in real spending in 1980. Declines in spending for consumer durable goods will offset gains in other areas of consumer spending. Government purchases should record a gain of 2.3 percent, with increases in federal spending totally offsetting the first annual decline in state and local government spending in the postwar period.

The economy should be in recovery by early 1981, with a winding down of the inventory liquidation process allowing the economy to record a modest real

OUTLOOK FOR REAL GROWTH
(percent change)

	1980				1981				Years	
	IA	IIA	IIIF	IVF	IF	IIF	IIIF	IVF	80F	81F
Gross National Product	1.1	-9.0	-3.0	-1.6	0.9	2.5	3.8	4.4	-1.3	0.2
Personal Consumption Expenditures	1.5	-9.8	1.9	0.8	-0.8	1.8	3.0	3.2	-0.4	0.4
Durable Goods	-1.1	-41.1	10.1	6.0	1.8	5.5	7.6	8.1	-9.0	-1.8
Nondurable Goods	-0.7	-5.5	-1.8	-1.4	-3.6	1.2	2.2	1.7	0.1	-1.2
Services	4.2	-0.8	2.5	0.7	1.1	1.2	2.2	2.8	2.2	1.3
Gross Private Domestic Investment	-7.5	-25.2	-27.7	-14.9	11.2	8.9	16.4	16.5	-14.7	-2.0
Fixed Investment	-4.9	-29.8	-11.1	-6.3	-3.3	3.9	8.8	11.7	-9.2	-3.4
Nonresidential	1.3	-15.4	-9.6	-9.3	-5.9	-2.0	3.9	7.2	-3.3	-5.1
Producers' Durable Equipment	0.4	-18.4	-7.7	-6.2	-5.1	1.3	4.5	8.1	-4.8	-4.0
Structures	3.2	-9.2	-13.1	-15.1	-7.7	-3.5	2.7	5.5	N.C.	-7.3
Residential	-19.8	-61.6	-16.6	7.4	4.1	26.2	25.8	26.3	-24.7	2.3
Change in Business Inventories ($)	N.C.	3.3	-6.0	-10.0	-4.0	-1.0	1.0	3.0	-3.0	0.2
Government Purchases	5.4	1.9	-0.4	-0.6	1.1	1.3	1.7	1.7	2.3	0.8
Federal	16.3	10.3	0.4	-3.0	1.5	2.3	3.4	3.8	6.7	1.5
State & Local	-0.7	-3.1	-0.7	0.9	0.9	0.7	0.7	0.5	-0.2	0.3
Net Exports ($)	20.8	28.1	28.0	27.5	27.5	26.5	26.0	25.7	27.1	26.4
Exports	13.5	-9.7	-4.3	-3.1	-1.6	1.6	3.2	5.5	7.0	-1.2
Imports	13.7	-21.6	-5.5	-2.0	-2.0	6.3	6.2	8.2	-1.2	-0.7
Final Sales	1.5	-9.8	-0.4	-0.5	-0.8	1.6	3.3	3.8	-0.4	N.C.

A=Actual F=Forecast N.C.=No Change

September 2, 1980

gain. The recovery should pick up momentum during the course of the year, but, on balance, this recovery should be the mildest first-year expansion of the postwar business cycle history. An average 10 percent rate of consumer price inflation is illustrative of the difficulties that the economy will face during its first full year of recovery. Persistently high rates of inflation will hold down the growth of real incomes for both consumers and businesses, thus inhibiting the spending rebound.

Employment and Production

The second quarter experienced a sharp reversal in employment and in industrial output. Production should continue to drop sharply in the current quarter, reflecting efforts to reduce inventory levels. Employment will mirror the trends in output, but the third-quarter decline in employment should fall short of the 3.7 percent drop in the second quarter. The dropoff in employment should accelerate in the fourth quarter, as inventory liquidation continues to reduce job requirements.

Industrial production is projected to decline during most of this year, with cutbacks especially pronounced in the manufacturing sector, notably durable goods production. On a quarterly basis, total industrial output should fall about 12 percent from its first-quarter peak in activity to its trough in the fourth quarter of this year. The decline in manufacturing production will be longer and more severe. Output in the manufacturing area reached its peak in third quarter of 1979 and, by the time output reaches its trough in the fourth quarter of 1980, manufacturing production will have suffered a nearly 14 percent decline.

The well-publicized drop in auto assemblies will account for a large share of the lower industrial production, with the industries supplying to the auto industries also experiencing cutbacks. The drop in homebuilding construction will translate into sizable declines in the production of construction materials. Energy conservation efforts will show up as a slowdown in electrical power generation, another depressant to output.

Declines in employment will translate into increased joblessness at least into early 1981. Somewhat offsetting, however, the growth of the labor force should moderate in the fourth quarter of this year, as potential job seekers become discouraged by the lack of job opportunities. These production and employment trends should result in steady increases in the rate of unemployment. By early next year the jobless rate could exceed the 9 percent high that was reached during the 1973-1975 recession.

A gradual rise in consumer spending and a pickup in auto sales and housing starts should begin to slow the drop in output by the fourth quarter and produce gains in production during the first quarter of next year. Inventory liquidation, however, will be a damper on output into the second quarter of 1981. A turnaround in capital spending should augment the rise in production during the second half of next year.

The 1981 gains in output should stimulate a gradual recovery in employment. Initially, the rise in jobs will fall short of the growth in the labor force. Thus,

EMPLOYMENT AND PRODUCTION OUTLOOK
(Millions)

	1980				1981				Years	
	IA	IIA	IIIF	IVF	IF	IIF	IIIF	IVF	80F	81F
Labor Force	104.2	104.7	105.3	105.7	106.1	106.5	106.9	107.3	105.0	106.7
% Change	1.8	2.0	2.3	1.5	1.5	1.5	1.5	1.5	2.0	1.6
Employment	97.8	96.9	96.7	96.4	96.5	97.0	97.6	98.3	97.0	97.3
% Change	0.6	-3.7	-0.8	-1.2	0.4	2.1	2.5	2.9	0.1	0.3
Unemployment	6.4	7.8	8.6	9.3	9.6	9.5	9.3	9.0	8.0	9.4
% Change	22.5	120.6	47.8	36.8	13.5	-4.1	-8.2	-12.3	34.2	17.5
Unemployment Rate %	6.1	7.5	8.2	8.8	9.1	8.8	8.7	8.4	7.7	8.8
Industrial Production‡	152.2	144.5	136.5	134.0	124.5	137.0	140.0	143.5	141.8	138.8
% Change	N.C.	-18.8	-20.4	-7.1	1.5	7.6	9.1	10.4	-6.8	-2.1
Manufacturing‡	152.7	143.7	135.0	132.0	132.5	135.0	138.0	141.5	140.9	136.8
% Change	-0.9	-21.4	-22.1	-8.6	1.5	7.8	9.2	10.5	-8.0	-2.9

‡=1967=100 A=Actual F=Forecast

INFLATION OUTLOOK
(percent change)

	1980				1981				Years	
	IA	IIA	IIIF	IVF	IF	IIF	IIIF	IVF	80F	81F
GNP Price Deflator	9.5	10.6	8.3	11.0	9.3	9.4	9.1	9.8	9.3	9.7
Consumer Price Index	16.8	13.7	6.2	10.0	10.6	10.3	10.1	9.8	13.1	.10.0
Producers' Price Index	17.0	9.4	14.0	10.4	10.6	10.3	10.1	9.8	13.2	10.7

A=Actual F=Forecast

September 2, 1980

increases in the jobless rate should extend into the first quarter of 1981. As order books expand, the demand for workers should rise, triggering the recall of many previously laid off workers. As the economic recovery takes hold, steady declines in the unemployment rate should occur during the final three quarters of the year. On balance, however, the anemic rise in real growth will not cause a dramatic decline in the unemployment rate, with the rate likely to persist above 8 percent even at next year's end.

PRICE OUTLOOK

A respite in the rapid surge of consumer price inflation should occur during the third quarter of this year. This moderating, however, will be short-lived. As hinted by the third quarter's acceleration in producers' prices, the economy will soon experience a renewed escalation in consumer price inflation. Double-digit rates of inflation should emerge in the fourth quarter of this year and characterize most of 1981. The composition of price increases may differ slightly from the early 1980 pattern.

Food prices will near the top of the list of inflationary pressures, rather than the moderating influence that they exerted on the early 1980 economy. This summer's drought and extreme heat caused considerable damage to crop, poultry, and livestock production. Thus, in contrast to the modest 4.7 percent rise in consumer food prices during the first half of 1980, retail food prices may soar 14 to 15 percent during the second half of this year. A marked escalation in grain prices this summer will push up food costs through higher prices for cereal and bakery products as well as an increased cost of meat production. In addition to the higher cost of livestock feedstocks, both cattle and hog production are on the low side of their cycle, implying limited supplies of meat products before year-end 1980. Tremendous losses in poultry production this summer will reverse the generally modest trend in poultry prices. This summer's drought should produce a high rate of inflation at least through the first half of next year, with higher prices for meat and poultry leading the advance.

Fuel price inflation may show some near-term moderating following the acceleration in energy costs during the 1979-early 1980 period. Prices of domestically produced petroleum may show increases through 1981 that are steeper than the rise in imported oil prices. Sharply higher prices for energy products have triggered cutbacks in energy usage, with burgeoning inventories of gasoline symptomatic of the cutback in demand. A slowdown in economic activity worldwide is trimming energy needs, and upward pressures on OPEC prices are moderating. The price decontrol program will contribute to sharply higher prices for domestically produced petroleum, and these prices will rise at a faster pace than the projected increase in OPEC prices. The accompanying table charts the likely cost of petroleum through 1981.

The third quarter easing in consumer price inflation is largely achieved through last spring's decline in mortgage rates. With mortgage rates rising again, inflation in the housing sector may become a rapidly rising price component by late 1980. Wage costs are aggravating the inflation outlook, as increases in compensation costs are combined with declines in productivity to produce a marked acceleration in unit labor costs. Although the recovering 1981 economy may result in productivity advances following two years of declines, scheduled increases in social security taxes and a catchup in wage increases, following many years of declining real earnings, should maintain a rapid rise in wage costs.

Combined with the fuel, food, housing, and labor cost pressures on prices, fiscal and monetary policies over recent years have built in substantial stimulation, thus adding the underlying rate of inflation. Although the Federal Reserve has met with near-term success in controlling the money supply within its stated growth targets, this recent success is only a first-step in reversing the stimulative impact of monetary policy. Persistently large budget deficits

SELECTED CRUDE PETROLEUM PRICES

	Avg. OPEC Price	Cost ($/barrel)			Percentage Change		
Year	($/barrel)	Imported	Domestic	Composite	Imported	Domestic	Composite
1977	12.88	14.53	9.55	11.96	—	—	—
1978	12.93	14.57	10.61	12.46	0.3	11.1	4.2
1979	18.67	21.67	14.27	17.72	48.7	34.5	42.2
1980	30.71	34.79	24.49	28.72	60.5	71.6	62.1
1981	35.49	39.88	36.19	37.70	14.6	47.8	31.3

and a growing share of government spending to the total economy provided substantial thrust to the inflation problem. With fiscal 1981 likely to register a record, or near record, deficit and with spending continuing to rise as a percentage of GNP, a reversal of the inflationary pressures posed by the government sector is not expected in the upcoming year.

CONSUMER SPENDING

The removal of the credit control program is bringing renewed strength to consumer spending. The record liquidation of debt in the second quarter caused an improvement in the debt-to-income ratios. During the second quarter credit extensions were more than 22 percent below the third quarter 1979 peak in activity. Extensions fell from 20.3 percent of disposable personal income in the third quarter to 14.7 percent last quarter. Although high rates of unemployment will prevent consumers from returning to past levels of borrowing exuberance, the second quarter's improvement in the credit burden suggests the potential for increases in borrowing and spending.

The pattern of consumer spending next year will be affected by the timing of tax relief. Based upon an assumed second quarter cut in taxes, spending in the first quarter could be held down by the impact of the large increase in the social security tax rate. Additionally, sharply higher food prices, resulting from this summer's weather-related crop damage, will boost the cost of consumer necessities early in the new year. Thus, total real consumer spending could decline slightly during the first quarter. The second-quarter tax relief should combine with a gradual recovery in employment to boost consumer take-home income and, correspondingly, consumer spending. Services spending should expand through 1981, but the volume gains of 2.2 and 1.3 percent for 1980 and 1981 respectively would represent the slowest back-to-back rise in real spending on services in the post-war period. Increases in utility rates to reflect the higher cost of petroleum products will encourage continued conservation. The financial difficulties of the airline industry may limit the amount of price discounting and, correspondingly, spending for air travel may be sluggish over the next year.

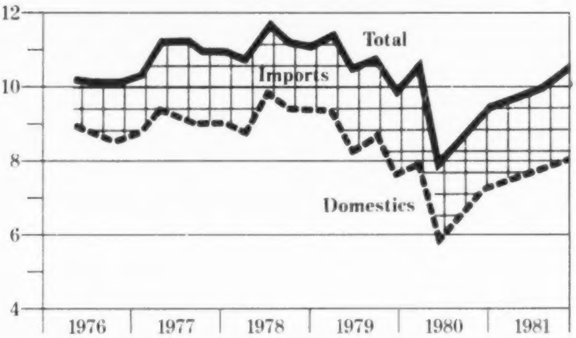
Real spending on nondurable goods should decline into the first quarter of 1981. High prices for food and fuel products should continue to check the volume of spending on these items, while sales of other nondurable goods should suffer from the adverse impact of high unemployment and slow growth in aftertax incomes. Although real spending on nondurable goods should be on the rise during the final three quarters of 1981, real spending should decline 1.2 percent for the year.

Spending on furniture and appliances should follow the trend of home sales. With mortgage rates increasing, home sales should slip and the sales of furniture and appliances should soften at least into early 1981. A gradual recovery in home sales and increasing consumer incomes should trigger a pickup in spending on household-related durable goods by mid 1981.

Auto Sales

Car sales apparently reached bottom in June. Model year-end price discounting and the allure of the more fuel efficient 1981 models should result in increased car sales during the second half of this year. Rising rates of unemployment, the high cost of financing, and the limited availability of the more fuel-efficient domestic models, however, should prevent a marked rebound in car sales. Sales in the fourth quarter may still average 2.4 million units below last January's near-term high of 11.7 million units.

Auto sales should continue their recovery during 1981, but the sales rebound should be subdued. Chrysler's fall, 1980 and GM's spring, 1981 introductions of their new line of small cars should encourage sales, but production of these models may be inadequate to meet the demand for fuel-efficient cars. Thus, some potential car buyers may postpone purchases, pending an increased availability and a proven track-record



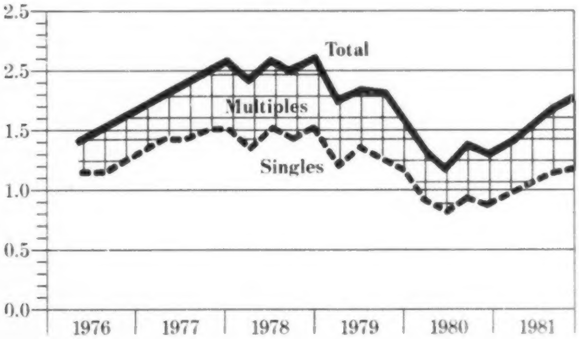
OUTLOOK FOR THE AUTO INDUSTRY
(millions of units)

of the new line of cars. Car sales, therefore, should increase about 10 percent next year, but even by the fourth quarter of 1981 sales should be nearly 1 million units below the January, 1980 near-term high in sales.

Imported car sales should slip from its first-half record share of the auto market. Introduction of new lines of domestic fuel-efficient, small cars may cut into foreign car sales. Additionally, foreign carmakers may voluntarily restrict imports to the U.S. for fear of trade restrictions. From a high of 28.2 percent in the second quarter of 1980, the share of the market may drop below 24 percent by year-end 1981.

HOMEBUILDING

Housing starts have rebounded briskly following May's low of 0.9 million units and, on the surface, many housing indicators, notably the 57.2 percent rise in building permits during the April through July period, point to a continuation of that recovery. Housing starts probably will increase through the third quarter, largely reflecting a fiscal year-end bulge in federally subsidized housing starts. The early August upturn in mortgage rates, however, will limit the number of potential homebuyers with the incomes to qualify for mortgage loans. The recent mortgage rate rise is beginning to affect home sales adversely and to cause builders to scale back their plans for new construction. Thus, housing starts probably will decline in the fourth quarter. Nonetheless, based upon the recent recovery in housing starts, spending on residential construction should increase by the final quarter of this year, in contrast to the record decline in spending during the second quarter.



HOUSING STARTS OUTLOOK FOR THE U.S.
(percent)

In spite of a generally uneven beginning to its recovery, residential construction should be the fastest growing sector of the 1981 economy. The early August rise in mortgage rates may be reversed by early 1981, expanding the pool of potential homebuyers with the incomes to qualify for mortgage loans. A marked lowering in mortgage rates next year will be prevented by the persistently high rate of inflation and by the regulatory changes that maintain a high floor to the cost of the six-month money market certificates and the 2½-year passbook accounts offered by savings institutions. Low rental vacancy rates and the strong underlying demand for homeownership will provide support for the housing outlook next year. Steady increases in housing starts are expected during 1981, with the composition of building activity favoring less expensive housing, such as apartments, condominiums, and townhouses, rather than the traditional single-family homes.

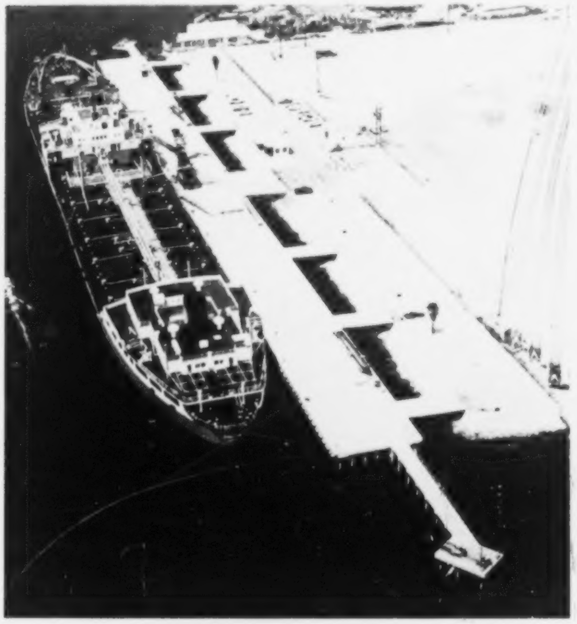
BUSINESS SPENDING

Capital and inventory investment should demonstrate substantial weakness into early 1981. Recent increases in nondefense capital goods orders indicate that a recovery is underway in the fleet purchases of motor vehicles following the second quarter's sharp decline. Reductions in spending for heavy machinery and industrial equipment, however, should produce declines in real spending on equipment into the first quarter of next year. Nonresidential construction should record sizable declines into next year. Industrial and commercial building permits have been on a steep slide since late 1979. On balance, business capital spending will decline through mid 1981, but the declines should be more moderate than the second quarter's 15.4 percent drop.

The sizable drop in industrial production expected through this year should reduce factory operating rates to around the 70 percent mark, a level not likely to stimulate large increases in capacity expansion projects. Corporate profits should be under considerable downward pressures throughout this year, thus reducing the amount of internally generated funds for capital expansion. The recent rise in short- and long-term interest rates will make debt financing an unattractively expensive source of investment funding.

Capital spending should begin to recover around mid 1981, stimulated by increases in consumer spending, rising operating rates, and investment-oriented tax breaks. Substantial increases in unit labor costs will encourage investment in equipment, while high energy prices should result in energy-saving investment. A 1981 investment tax incentive should provide a catalyst for increases in capital spending. Corporate profits should improve with the rise in production activity, and some lowering in interest rates from the late summer, 1980 levels should improve the prospects for external financing. On balance, interest rates will remain at historically high levels, mirroring the relatively high rate of inflation. Thus, the recovery in capital spending even by late 1981 should be somewhat modest.

Until the second quarter of this year, inventories were lean relative to sales. The steep second-quarter drop in sales caused inventory levels to be high despite sizable cutbacks in industrial production. Although some inventories have been worked down, inventory levels in the consumer area, notably for durable goods, suggest the potential for inventory liquidation in the upcoming quarters. Substantial inventories of petroleum products are boosting total stock levels, and due to a shortage of storage facilities, some trimming of oil inventories may be forthcoming.



A gradual recovery in consumer spending will initially speed the inventory liquidation and will contribute to a rebuilding of stocks around mid 1981. An upturn in capital spending by the second half of next year should also boost inventory requirements while increases in federal defense spending will produce a buildup of inventories in various stages of processing.

TRADE DEVELOPMENTS

The U.S. recession should put a lid on import demand and contribute to relatively small deficits in the merchandise trade account. The deficit on the net export position should narrow in the second half from the $2.5 billion deficit in the second quarter. This improvement in net exports may be shortlived. Following a $1 billion deficit in the third quarter, the deficit is projected to double in the fourth quarter. Slowing economic activity abroad and a gradual recovery in U.S. consumer spending will be prime reasons for a widening in the deficit.

Steady increases in the net export deficiency should be recorded over 1981. The U.S. recovery coupled with generally sluggish business activity among the other major industrialized countries will generate increases in U.S. imports, and slow growth in U.S. exports.

CORPORATE PROFITS

Pretax corporate profits fell at an annualized rate of 58.7 percent during the second quarter of this year. The sharp drop in production and a reduction in the level of inventory profits contributed to this major correction in corporate profits. The $48.2 billion drop in pretax earnings was the sharpest dollar decline of the postwar period, while the 58.7 percent fall was the third largest percentage decline.

Real output in the nonfinancial corporate sector fell 10.7 percent in the second quarter, while costs in that sector rose sharply, in part reflecting the windfall oil profits tax and the sharp rise in interest rates. Unit labor costs, which represent over 68 percent of total costs and profits in the nonfinancial corporate sector, rose 12.4 percent. The sharp contraction in real output and the steady rise in corporate costs caused operating profits in the nonfinancial corporate area to fall 36 percent. Additionally, a moderating in wholesale price inflation triggered a $35 billion drop in inventory profits, thus compounding the decline in operating earnings. Pretax profits in the nonfinancial corporate sector dropped nearly 63 percent in the second quarter.

OUTLOOK FOR CORPORATE PROFITS
(Billions of Dollars)

	1980				1981				Years	
	IA	IIA	IIIF	IVF	IF	IIF	IIIF	IVF	80F	81F
Operating Profits	175.0	156.0	139.0	135.0	132.5	140.5	146.5	154.0	151.3	143.4
%Change	-3.1	-36.9	-37.0	-11.0	-7.2	26.4	18.2	22.1	-15.5	-5.2
%Change Year Ago	-2.2	-11.7	-23.1	-23.5	-24.3	-9.9	5.4	14.1		
Inventory Adjustment	-63.2	-28.2	-33.0	-28.0	-27.0	-28.0	-28.0	-29.0	-38.1	-28.0
Capital Consumption Adj.	-22.2	-24.6	-26.0	-28.0	-29.0	-22.5	-22.5	-23.0	-25.2	-24.2
Pretax Book Profits	260.4	208.8	198.5	191.0	189.0	191.0	197.0	206.0	214.7	195.8
%Change	31.9	-58.7	-18.3	-14.3	-4.2	4.3	13.2	19.6	-9.6	-8.8
%Change Year Ago	11.6	-8.4	-18.1	-21.4	-27.4	-8.5	-0.8	7.9		
Aftertax Book Profits	158.0	129.3	122.5	116.5	115.0	116.5	121.0	126.0	131.6	119.6
% Change	37.3	-55.1	-19.4	-18.2	-5.1	5.3	16.4	17.6	-9.0	-9.1
% Change Year Ago	12.0	-7.2	-17.4	-20.7	-27.2	-9.9	-1.2	8.2		
Capital Consumption Allow.	137.4	139.3	144.0	148.5	153.0	160.0	164.5	169.0	142.2	161.6
Dividends	56.7	58.6	59.0	60.0	61.0	62.0	63.0	64.0	58.6	62.5
Cash Flow After Dividends	238.7	210.0	207.5	205.0	207.0	214.5	222.5	231.0	215.2	218.7
% Change	20.8	-40.1	-4.1	-4.7	4.0	15.3	15.8	16.2	-3.5	1.6

A = Actual F = Forecast

Corporate profits should continue lower during the second half of this year. Output cutbacks and persistently large increases in labor and nonlabor costs will produce steady declines in profits from current production. Inventory profits may pick up in the third quarter, reflecting that quarter's acceleration in wholesale price inflation. Despite that increase, reported profits should decline steadily through the remainder of this year.

For all of 1980, operating profits will show a decline that is steeper than the decline experienced by book profits. Output in the nonfinancial corporate sector should decline by more than 2 percent this year, while costs in that sector should continue to rise briskly. Net interest charges will show the steepest advance of the various cost components, while unit labor costs will experience a 10.3 percent surge over 1979's level. Due to the acceleration in corporate costs and the decline in corporate output, unit profits in the nonfinancial corporate sector will fall 17.2 percent this year.

A recovery in corporate profits should begin around the second quarter of 1981. Although the economy may begin to recover in the first quarter, a sharp rise in unit labor costs triggered by the first quarter's increase in social security taxes will put a squeeze on operating profits during that period. The second-quarter recovery in earnings will be held down slightly by the rise in book depreciation costs, resulting from the assumption that a liberalization of depreciation allowances will be implemented in the second quarter.

The recovering 1981 economy should allow a 0.5 percent expansion in real spending in the nonfinancial corporate sector. The rise in corporate costs may moderate slightly from the 1980 experience. Cost pressures should remain substantial, thus producing a decline in unit profits next year. As in 1980, net interest costs will represent the fastest growing category of unit costs during 1981. Unit labor costs are projected to increase 10 percent, while unit profits may sustain a 10.8 percent decline. Moderating inflation rates and the assumed tax breaks will contribute to a lowering in the inflation adjustments to profits. Thus, the decline in reported profits will exceed the decline expected in 1981's operating profits.

INTEREST RATES

This summer's upturn in rates is probably attributable, in large part, to the removal of credit controls and an increase in credit demands artificially held down by the control program. As this special circumstance works through the financial system, interest rates are likely to be influenced by such fundamentals as the growth of the money supply, the demand for credit, and the trend of inflation.

The money markets reacted strongly to the record increase in the basic money supply during early August and are watching the monetary aggregates closely as the harbinger of future Federal Reserve open market operations. If the Federal Reserve continues to meet with success in keeping the monetary aggregates within their target ranges, fears may subside that a substantial tightening in Fed policy is forthcoming. Thus, money markets may become less apprehensive about the future availability of credit.

Business demands for credit should be sluggish into 1981, reflecting cutbacks in capital spending and a liquidation of inventories. Additionally, declines in internally generated funds, resulting from a reduction in corporate profits, should trigger additional cutbacks in capital spending. This spring and summer's surge in new intermediate and long-term debt offerings suggests that many corporations were able to restructure their debt away from short-term obligations. Thus, reduced dependency on short-term credit and the declining credit demands of a slumping business sector should moderate the upward pressures on short-term interest rates at least into early 1981.

The turnaround in mortgage rates should dampen the demand for mortgage financing, and a fourth-quarter slump in home sales should temper the upward pressures on mortgage rates. Some decline in mortgage rates should occur before this year's end. A return to below 12 percent mortgage rates, however, is not likely, considering the cost of funds to thrift institutions and the high underlying rate of inflation.

The expected trends in the money supply and credit demands suggest that short-term interest rates will decline during the fourth quarter and into the new year. Inflation developments, however, should limit the downturn in interest rates, most notably long-term rates. With consumer and producers' price inflation likely to be around 10 percent by late this year and throughout 1981, long-term interest rates are likely to remain above 10 percent, thus checking a future rally in bond prices.

As the economy recovers during 1981, interest rates should respond to the increased credit demand of an expanding economy. A pickup in business spending around mid 1981 will combine a sizable amount of Treasury debt financing to produce increases in interest rates beginning in the second quarter of 1981. The Federal Reserve's preliminary targets for 1981 money supply growth suggest a generally restrictive policy through next year and only moderate growth in bank credit. Thus, as the economy expands through 1981, interest rates should increase.

INTEREST RATE ASSUMPTIONS

	1980				
	1A	IIA	IIIF	IVF	YearF
Moody's AAA Corporate	12.14	11.20	11.50	10.75/11.00	11.40/11.46
Salomon AA new issue utility†	13.43	12.02	12.50	11.50/11.75	12.36/12.43
1-year Treasury bill rate	12.48	9.39	9.10	8.00/8.25	9.74/9.81
90-day Treasury bill rate	13.35	9.62	8.90	7.75/8.00	9.91/9.99
90-day dealer commercial paper	14.54	11.18	9.24	8.00/8.25	10.73/10.79
Prime rate	16.58	16.33	11.40	10.50/10.75	13.70/13.77

	1981				
	1F	IIF	IIIF	IVF	YearF
Moody's AAA Corporate	10.50/10.75	10.25/10.50	10.50/10.75	10.75/11.00	10.50/10.75
Salomon AA new issue utility†	11.00/11.25	11.00/11.25	11.25/11.50	11.50/11.75	11.19/11.44
1-year Treasury bill rate	8.00/8.25	8.50/8.75	8.50/8.75	9.00/9.25	8.50/8.75
90-day Treasury bill rate	7.75/8.00	8.00/8.25	8.00/8.25	8.50/8.75	8.06/8.31
90-day dealer commercial paper	8.00/8.25	8.25/8.50	8.50/8.75	9.00/9.25	8.44/8.69
Prime rate	10.25/10.50	10.00/10.25	10.25/10.50	10.75/11.00	10.31/10.56

A = Actual F = Forecast † Deferred Call

(Note: All treasury bill yields calculated on discount basis.)

Economic Policy Prescriptions

The election/recession year of 1980 presented difficult challenges to economic policymakers. High rates of unemployment and inflation called for conflicting policy responses, and measures designed to attack one problem often aggravated the other. The policy record for 1980 showed that many bold and innovative measures were proposed, often implemented, and sometimes rescinded, making the past year an interesting period to study economic stabilization policies. The outlook for 1981 indicates that unemployment and inflation will persist at high rates, suggesting that the current challenges will continue to plague policymakers.

FISCAL POLICY

Although fiscal policymakers did not prescribe the old-time, election-year medicine of tax cuts and spending increases, the fiscal 1980 federal budget was quite stimulative. According to the July budget revision, spending for the 1980 fiscal year, estimated around $580 billion, will increase 17.5 percent over 1979, accounting for 23.1 percent of GNP or about 2 percentage points more than the prior year's share. Despite the absence of a 1980 tax cut, the $517 billion estimate for federal receipts represents an 11 percent rise over 1979, the smallest revenue increase since the tax-cut year of 1976. The estimated $63 billion deficit for the 1980 fiscal year is the largest red-ink figure since 1976 and marks the second largest deficit of the postwar history.

Deficit Spending

These budget figures paint a picture of stimulus, perhaps the wrong type of medicine for a year which will record the largest rise in consumer prices since 1947. The budgetary stimulus, however, does not have a short history, but, instead, its roots are steeped in the postwar history. From 1947 to 1960, the budget was in surplus in seven years and in deficit in five years (one deficit represented Korean wartime spending). Since 1960, the unified federal budget has been in deficit nineteen out of the past twenty years. During the 1960-1980 period, the deficits totaled more than $400 billion, and more than 60 percent of the deficit occurred between fiscal years 1976 and 1980, a period of economic expansion.

High Employment Budgets

Translating the recent budget history to a full employment basis, the high-employment budget was in deficit in every year between fiscal 1976 and 1979 and was in deficit during the first two quarters of the 1980 fiscal year. These estimates are based on the government's official estimate that the full-employment unemployment rate (FEUR) is around 5.1 percent. Due to the shift in the composition of the labor force, a good case could be made that a realistic estimate of the FEUR is closer to 6 percent than to 5 percent. Based on a higher number for the FEUR, fiscal policy has been even more stimulative than is indicated by the official estimates for the high-employment budget.

Spending Share to GNP

From fiscal 1960 to fiscal 1976, the proportion of federal outlays on a national income account basis to GNP trended upward from 18.4 percent to 22.9 percent, but then fell steadily to 21.3 percent by fiscal 1979. During the 1980 fiscal year, the recent declining trend was dramatically reversed, and spending equaled a proportion of 23.1 percent. Additionally, the sizable increase in 1980's outlays will provide a large base for fiscal 1981 spending, and, in spite of attempts to trim that budget, the proportion should equal 23.4 percent, representing the largest share in the postwar period.

This share of federal outlays to GNP is affected by both increases in federal spending and cutbacks in the private economy. Thus, this concept may not accurately describe how restrictive or stimulative fiscal policy has been. The steadily rising share of spending, however, does portray the government's growing presence in such areas as the credit, labor, and raw materials markets. The persistent growth in the size of federal government relative to the rest of the economy may be cited as a factor contributing to the high rate of inflation and the slow growth in productivity.

The 1981 Tax Cut

The outlook for the 1981 economy includes an assumption that a tax cut will be implemented probably before midyear. A good case could be made that tax cutting is appropriate for next year. Without a cut, federal tax receipts are projected to increase $85 billion in the 1981 fiscal year. This increase includes about $15 billion in higher social security taxes, $20-25 billion in increased taxes on "windfall" oil profits, and about $15-20 billion in higher taxes resulting from the inflation creep into higher tax brackets.

The tax burden is becoming more onerous. During 1979 federal personal tax receipts equaled 12 percent of personal income, second highest in the postwar period to the 12.5 percent share in 1969 when the 10 percent tax surcharge was imposed to finance the Vietnam War. Considering that federal social insurance contributions have increased by 2 percentage points as a share of personal income during the 1969-1979 period, last year's tax burden represented a record amount. Without a tax cut and with the scheduled increase in social security taxes, the overall tax burden will continue to grow in 1981.

Although the economy should be in a recovery stage during 1981, it is likely to be quite anemic, suggesting that only a minimal lowering in the rate of unemployment will occur. A tax cut in 1981 would help to stimulate consumer spending, production, and employment. Assumed in the 1981 economic outlook is a $30 billion tax cut effective around midyear. Consumers would receive about two thirds of that tax cut, with the $20 billion personal income tax cut taking the form of either an across-the-board reduction in tax rates or through a series of tax credits and other reductions. The precise shape of the cut will hinge on the outcome of the general election. The approximately $10 billion in corporate tax cuts is assumed to be split between an accelerated depreciation and a reduction in corporate income tax rates. Again, whether the 10-5-3 plan for depreciation allowance, constant rate depreciation, or another liberalization scheme is approved, will hinge on the election.

Tax Proposals

By late August, the Democratic and Republican Presidential candidates and the Senate Finance Committee unveiled specific tax cut proposals. The following table sketches the main features of the various proposals.

Though varying in size and composition, all three

VARIOUS TAX PROPOSALS

Feature	Carter		Reagan		Senate Finance Committee	
Breakdown	Individuals Business Total	$12.5 (45%) $15.1 (55%) $27.6 billion	Individuals Business Total	$22-25 (81-78%) $ 5- 7 (19-22%) $27-32 billion	Individuals Business Total	$22 (56%) $17 (44%) $39 billion
Major Provisions	$12.8 billion Employers & employees granted credits equal to 8% of the social security taxes they pay $4.7 billion Reduce marriage penalty $6.3 billion Faster & simpler writeoffs for capital investment $2.4 billion Special writeoffs for some hard-hit industries $1.4 billion Aid for rail, highway & R&D		Reduce income taxes by 10% for individuals Allowance for faster writeoffs for capital investment		INDIVIDUALS $100 billion —Increase personal exemption —Increase zero bracket amount —Reduce marriage penalty $12.0 billion Reduce individual tax rates BUSINESS $11.0 billion Faster writeoffs for capital investments $2.5 billion Reduce top capital gains tax rate and raise capital gains exclusion $1.5 billion Decrease corporate tax rate $2.0 billion Other provisions	

are designed to compensate slightly, but not totally, for the scheduled increases in taxes during 1981 as well as to provide longer-term stimulus to capital investment. The programs are sufficiently different to form the basis for many hours of Congressional debate. With Congress scheduled to recess on October 3 for election year campaigning, there are few days remaining before the November 4 general elections that Congress will be in session. Thus, a pre-election tax cut is highly unlikely, and a tax cut probably will not be approved until the second quarter of 1981.

1981 Spending

Next year's budget spending deficit may approximate the $63 billion deficit that the Congressional Budget Office (CBO) has estimated for fiscal 1980. High rates of unemployment and a tax cut late in the 1981 fiscal year should hold down the rise in revenues to about 10 percent, not the 16.5 percent growth estimated by the CBO and the Administration. In order to maintain the 1981 budget deficit in a $60 to $65 billion range and still provide for a tax cut, a marked slowdown must occur in the growth of federal outlays. With revenues estimated around $570 billion, a $65 billion deficit would result if outlays equaled $635 billion. That level of expenditures would represent a 9.5 percent rise in spending, a near halving of the 17 to 17.5 percent growth in outlays during the 1980 fiscal year.

The $635 billion spending total represents a 23.4 percent share of GNP, up from the 23.1 percent share in fiscal 1980. The 9.5 percent growth in spending will require a slowing in most spending categories, with a notable exception being defense expenditures. Part of the slowdown in spending growth during fiscal 1981 should result from interest rates that average below the fiscal 1980 levels. Additionally, inflation rates in the upcoming fiscal year should be lower than in the prior year, thus inflation adjustments to the government's entitlement payments will be less than in fiscal 1980. The rise in unemployment benefit payments should moderate in the upcoming fiscal year, reflecting a slowdown in unemployment and an eventual increase in employment.

A major uncertainty in the spending outlook is posed by possible increases in jobs spending programs. The Democratic platform recommended a $12 billion jobs program, while the Administration has proposed a $4 billion program. Concern over greatly escalating the fiscal 1981 deficit may cause some spending programs to be implemented with offsetting spending cuts in other areas or through a delay in the effective date of tax cuts.

On balance, however, the budget deficit in fiscal 1981 may be headed for a record $65 billion plus. That amount of stimulus coupled with the deficit's pressures on credit markets should add to the inflationary ary bias in the economy. The burden of fighting inflation, therefore, may remain squarely on the shoulders of monetary policymakers.

MONETARY POLICY

Judged by growth rates of the monetary aggregates and bank credit, monetary policy was stimulative during the expansionary period from 1976 through 1979. As indicated in the following table, the aggregates and the bank credit grew rapidly as the economy moved closer to full utilization of its resources. In retrospect, the Federal Reserve should have been more aggressive in pursuing slower growth rates of the aggregates and credit especially in the 1977-1979 period. The failure to curb the growth of money and credit is a contributing factor to the current problem of very high rates of inflation.

October 6th Actions

The Federal Reserve moved decisively toward restrictiveness on October 6, 1979. The discount rate was increased from 11 to 12 percent, and a marginal reserve requirement of 8 percent was imposed on managed liabilities of member banks, Edge Act corporations, and U.S. agencies and branches of foreign banks. Probably the most significant Fed action was the October 6 shift in monetary policy focus from controlling interest rates to controlling bank reserves in order to insure that the Fed's objectives for money supply growth would be achieved.

Reaction in the financial markets to the October 6 actions was swift and severe. Nominal interest rates rose rapidly in October, and business loans trended down throughout the fourth quarter. The growth of

ECONOMIC CAPACITY AND GROWTH OF MONETARY AGGREGATES

	Capacity†	M-1A	M-1B	M-2	M-3	Bank Credit
1975	92.3	4.7	4.9	12.3	9.4	4.1
1976	94.9	5.5	6.0	13.7	11.4	7.7
1977	97.0	7.7	8.1	11.5	12.6	11.1
1978	98.3	7.4	8.2	8.4	11.3	13.6
1979‡	98.1	5.7	8.8	9.2	9.9	13.6

Growth of the monetary aggregates expressed as fourth quarter percentage increase.

† Real GNP as a Percentage of Potential GNP

‡ The index is based on an average of the first through third quarters; growth of the aggregates reflects growth from the fourth quarter 1978 to third quarter, expressed as a compound annual rate of increase.

the monetary aggregates slowed in the fourth quarter and slowed further in the first quarter of 1980. The shift in policy focus away from interest rates to money supply control has brought increased volatility to interest rates, but the shift has had the desirable impact of causing the achievement of the money supply targets to have a higher priority than may have been the case prior to October 6.

March 14th Program

Pressure from the Carter Administration and from the foreign exchange and commodity markets forced the Federal Reserve to move toward greater restrictiveness during February and March of this year. With hindsight, it is clear that the early 1980 credit policies, especially those adopted with the President's March 14 anti-inflation program, were a mistake. Monetary policy typically affects economic activity with a six to nine month lag. Rather than waiting that interval to determine the success of the October 6 moves in dampening inflationary pressures, soaring inflation rates, largely resulting from OPEC pricing and speculative pressures in the metals and housing markets, triggered a discount rate hike and reserve tightening in mid February and an unprecedented peacetime imposition of credit controls on March 14.

The March 14 moves included the following monetary measures:

- A 15 percent reserve requirement on increases, after March 14, in outstanding consumer unsecured credit and in assets of money market mutual funds.
- A 3 percentage point penalty on the discount rate for excessive borrowers from the Fed.
- A limit of 6 to 9 percent on the 1980 growth of bank loans.
- An increase to 10 percent in the marginal reserve requirement on managed liabilities of both member and nonmember banks.

These moves had massive psychological and real effects that propelled the economy, especially consumer spending, into a free fall. These measures added considerable downward momentum to an econonomy that had already peaked in January. Virtually all the financial and economic statistics for the March through May period provided a consistent picture of an economy in a steep tail-spin.

Even without the benefit of hindsight, the March 14 credit policies aggravated a trend of waning credit demand. The growth in consumer credit was easing, while the record high interest rates that prevailed prior to March 14 were taking the steam out of business demand for credit. Also, the monetary authorities were already shouldering an inordinate share of the burden of fighting inflation, while fiscal policy continued on a relatively stimulative posture. The March 14 credit policies only increased the policy burden on the Federal Reserve.

The credit policies of March 14 were dismantled gradually, beginning in May, and removed completely by the end of July. Although consumer borrowing activity may show an end to the liquidation process, a marked recovery in borrowing may not occur during the forecast period.

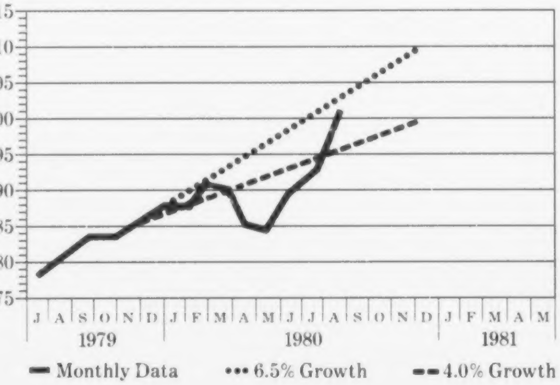
Money Supply Growth

The Federal Reserve did achieve success in slowing the growth of the monetary aggregates. Both M-1A (currency plus checking accounts at commercial banks) and M-1B (M-1A plus interest-bearing checking accounts at banks and thrift institutions as well as credit union and mutual savings bank accounts) fell below the lower bound for their growth targets in early April and remained below the target range through July. During early August, however, record increases in the basic money supply propelled M-1A to the midpoint of its range and M-1B near to the top of its range. Additionally, M-2 (M-1B plus checklike accounts at nonbanking institutions) exceeded its target range during July.

Regulatory Changes

The economy in 1981 will present a difficult challenge to monetary policymakers. The Federal Open Market Committee (FOMC) will be required to strike a balance between the short-run, countercyclical objective of stimulating the economy following a severe recession and the long-run objective of significantly reducing the rate of inflation. And this balance must be struck in a year when significant changes are planned for financial institutions.

GROWTH TARGETS OF MONEY STOCK
M1-B
($ billions)



MONETARY GROWTH TARGETS FOR 1981

	M-1A	M-1B	M-2	M-3	Bank Credit
1980 Targets	3½-6%	4-6½%	6-9%	6½-9½%	6-9%
Adjustment for 1981	-½%	-½%	-½%	N.C.	N.C.
1981 Targets—no regulatory changes	3-5½%	3½-6%	6-9½%	6½-9½%	6-9%
Impacts of regulatory changes:					
1. Shift from demand deposits to NOW accounts	-3%	—	—	—	—
2. Shift from savings to NOW	—	+1½%	—	—	—
3. Shift from open-market instruments to money market funds	—	—	0	—	—
1981 Growth Targets	0-2½%	5-7½%	5½-8½%	6½-9½%	6-9%

The Depository Institutions Deregulation and Monetary Control Act of 1980 was made law on March 31, 1980. The omnibus bill requires, in addition to many other changes, an eight-year phase-in of reserve requirements for non-Fed member banks and allows for the payment of interest on bank reserves held by the Federal Reserve. The bill provides for a six-year phase-out of the Regulation Q ceilings on interest rates and for the establishment of NOW (negotiable orders of withdrawal) accounts, with implementation scheduled to begin on January 1, 1981.

Fed Targets

The Federal Reserve's stated objective for 1981 is to lower the growth ranges of M-1A, M-1B, and M-2 by one half percent, given the existence of no regulatory changes. The growth ranges for M-3 and bank credit remain unchanged from their respective 1980 targets. There are three specific impacts of regulatory changes for which the Federal Reserve must adjust these growth ranges. The Federal Reserve has emphasized that the estimates of these impacts are preliminary and subject to revision.

1. The shift from demand deposit accounts at commercial banks to NOW accounts is expected to lower M-1A growth by an amount from 1 to 5 percentage points.
2. The shift from savings and other small denomination time deposits is expected to raise M-1B growth by ½ to 2½ percentage points.
3. A shift from open-market instruments to money market funds could be expected to increase M-2 growth, but the impact of this shift is currently expected to be insignificant relative to the desired growth range of M-2.

The midpoints of the estimates of these institutional changes were used by Fed Chairman Volcker in arriving at his preliminary growth ranges for 1981.

Outlook for Federal Reserve Policy

The record surge in the monetary aggregates for the week ending August 6 added to the recent upward pressures in money markets. With the free fall in economic activity over and the outlook for inflation worsening, monetary policymakers probaby cannot veer too far from a restrictive policy. Containing the growth of the aggregates must remain the paramount focus of policy, and restraining the growth of reserves and credit following the removal of the credit restrictions may cause the Federal Reserve to allow interest rates in the near-term to trade higher than had been the case when the monetary aggregates were substantially below the target levels. The Federal Reserve is likely to maintain a relatively restrictive stance into 1981, barring an economy that shows subtantially greater weakness than is projected in our economic outlook. Additionally, likelihood that some fiscal stimulus will be approved next year will reduce the pressure on the Fed to move aggresively toward ease.

Though the 1981 economy is expected to grow relatively slowly in real terms, a nominal growth on the order of 12 to 13 percent appears likely. It would seem that in 1981 the Federal Reserve has little latitude to reduce target ranges for the monetary aggregates below 1980 levels. For example, if velocity were to grow as rapidly as it did in the first year of recovery following the last recession, it could indicate a growth rate of M-1B within the current target range of 4.5 to 6 percent. The 7.6 percent increase in velocity that occurred then, however, was very large, far surpassing the growth in velocity that followed the 1960-1961 and the 1969-1970 recessions. Moreover, with the introduction of nationwide NOW accounts leading to a more rapid growth of M-1B, growth rates as low as the present target range for M-1B may be difficult to achieve.